THE STATE OF PAKISTAN'S ECONOMY

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1 Overview

After facing some headwinds in the initial months of the fiscal year, the economy ended the first half of FY15 with some notable positives:

- Most significant was the sharp improvement in the external account, as the sudden fall in international oil prices along with strong growth in remittances, helped contain the current account deficit in Q2-FY15.[1] This, along with the disbursement of tranches from the IMF, and the successful issuance of Sukuk in the international market, pushed up the country's foreign exchange reserves to a comfortable level.

- The resulting stability in the exchange rate, and the fact that the government passed on the benefit of lower global oil prices to domestic consumers, not only softened inflationary expectations, but also pulled down headline CPI inflation to a decade-low.[2] SBP, therefore, responded by softening its monetary policy stance in November 2014, for the first time since June 2013.

- Fiscal data indicates that the government was able to contain its deficit mainly due to low growth in expenditure during H1-FY15. Also, the financing mix improved as increased external funding reduced the burden on the banking system, particularly on the central bank. Consequently, for the first time in the current IMF program, the country met *all* the quantitative (performance) targets for end-December 2014 (**Chapter 3**).

Having said this, the persistent structural weaknesses continue to take a toll on the country's overall economic performance. For example, energy shortages continue to be a serious issue, which held back growth in a number of industries. Similarly, Pakistan has not been able to attract sufficient foreign direct investment, even when our peer countries are experiencing rising FDI inflows. Moreover, tax revenue growth remains sluggish despite several measures introduced during the year; and the losses in Public Sector Enterprises (PSEs) remained a burden on scarce fiscal resources, as the restructuring and privatization program of PSEs could not gain momentum as expected.

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[1] The current account deficit in Q2-FY15 was only US$ 770 million, compared to US$ 1.6 billion in the preceding quarter, and US$ 688 million in the same quarter last year.

[2] We believe the YoY decline in the prices of perishable items and the lagged impact of monetary tightening in the past also contributed to ease in CPI inflation.

In this context, the windfall gain from the collapse in international oil prices, low inflation, and the improvement in balance of payments, provide an opportunity to expedite difficult structural reforms in the energy sector, PSEs, revenue generation, and overall governance, to put the economy on a higher growth trajectory.

Review of H1-FY15

Preliminary information about the real sector suggests a mix picture of the economy. Prospects of a better wheat crop, and some improvement in minor crops, are likely to offset the performance of cotton and sugarcane. However, farmers' income may be adversely affected by higher input cost (especially fertilizer), and the decline in output prices of cash crops.

Table 1.1: Selected Economic Indicators

	H1-FY14	FY15 Targets	H1-FY15
Growth rate (percent)			
LSM[a]	6.6	7.0	2.3
CPI (period average)[a]	8.9	8.0	6.1
Private sector credit [b]	9.6	na	6.0
Money supply (M2)[b]	6.0	na	4.4
Exports (customs)[a]	4.9	5.3	-4.4
Imports (customs)[a]	-1.1	4.2	11.7
Tax revenue -FBR (billion Rs)[c]	1,031.5	2,691[#]	1,171.9
Exchange rate (+app/-dep%)[b]	-5.4	na	-1.7
billion US dollars			
SBP's reserves (end-period) [b]	3.5	na	10.5
Worker remittances [b]	7.8	16.7	9.0
FDI in Pakistan [b]	0.4	4.3	0.5
Current account balance [b]	-2.0	-2.8	-2.4
percent of GDP[*]			
Fiscal balance[d]	-2.1	-4.9	-2.2

*: Based on the full-year GDP estimates stated in the Annual Plan for 2014-15. na=: not applicable.
#: Original FBR target was Rs 2,810 billion.

Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

Large scale manufacturing (LSM) showed modest growth of 2.3 percent during H1-FY15, less than half the growth achieved during the same period last year (**Table 1.1**).[3] While the persistent energy shortages (especially of gas) constrained activity in textiles, paper, leather & glass, the delay in cane crushing took its toll on sugar production in the first half of the year.[4] However, a number of other sectors showed healthy growth, e.g., automobiles, electronics, and construction related industries like cement, steel, glass & paints, and rubber products. These sectors benefited primarily from a decline in global iron, steel and coal prices.

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[3] However, this growth number for LSM should be used with caution, given some issues in the compilation of LSM data (see **Chapter 2** for detail).
[4] It is expected that sugar production would remain low in the full year, as sugarcane production declined by 5.3 percent over the last year.

While hard numbers for services are not available, we believe it will be challenging to achieve 6.1 percent growth in *wholesale and retail trade* (the largest sub-sector of GDP[5]) due to the weak performance of commodity producing sectors. However, overall services can benefit from encouraging performance of communication, finance & insurance, and government services.[6] While communication services are expanding following the auction of 3G/4G spectrum licenses, the value addition by *finance and insurance* is set to take advantage from strong profitability of the banking sector, primarily driven by massive investments in risk free government securities and increasing income from other banking services.

More specifically, commercial banks' investment in government securities increased by Rs 667.6 billion during H1-FY15, to Rs 4,735.0 billion. Throughout this period, commercial banks participated aggressively in primary auctions of longer-term securities as they anticipated a cut in the policy rate and also took advantage of the healthy term premium on PIBs. The government also accepted huge sums in these auctions to lengthen the maturity profile of its debt, and to substitute some of its borrowings from SBP. This enabled the government to contain its borrowing from SBP within the ceiling agreed with the IMF for end December 2014,[7] and meet the limit of zero quarterly net borrowing from the central bank under the amended SBP Act 1956.

Significant government borrowing from commercial banks, partly contributed to low private sector credit off-take, which was Rs 222.3 billion during H1-FY15, compared with Rs 321.3 billion in the same period last year. On the other hand, demand for bank loans was also low due to soft commodity prices (especially cotton, rice, and sugar cane), and a slowdown in LSM.

Encouragingly, the benefit of reduced international oil prices was passed on to consumers in Pakistan, to a larger extent compared with peer economies (see **Box 1.1**). This, along with a stable exchange rate and softened inflationary expectations, led to a steep fall in CPI inflation from 8.9 percent in H1-FY14, to only 6.1 percent during H1-FY15. As these factors are expected to prevail also in the remaining part of the year, the current low inflationary trend is likely to

[5] Wholesale & retail trade has a share of 20.2 percent in the GDP, followed by livestock (13.2 percent) and large-scale manufacturing (11.6 percent).
[6] Government expenditures on campaign against militancy, and facilitating internally displaced peoples (IDPs) are also counted towards value added by *General government services* – a sub sector of GDP.
[7] This also allowed SBP to meet its NDA ceiling agreed with the IMF for end December 2014.

continue. In fact, the results of IBA-SBP's Consumer Confidence Survey (CCS) also indicate subdued inflationary outlook (**Chapter 3**).

These developments allowed for a policy reversal: SBP reduced the policy rate by 50 bps in November 2014 – after keeping it unchanged for a year. SBP further reduced the policy rate in the subsequent two monetary policy decisions, by a cumulative 150 bps, taking it to a decade low of 8.0 percent. SBP supplemented these decisions with increased OMO injections from November 2014 onwards.[8] Crossing the level of Rs 500 billion in December 2014, these injections helped commercial banks meet the liquidity needs of both the government and private sector.

The cut in policy rate also helped normalize the earlier disconnect between T-bill and PIB segments of the yield curve. T-bill yields declined in line with the cut in policy rate, but the impact on PIB yields was more pronounced as banks were more aggressive in bidding up their prices (which reduced yields). This trend was supported by relatively low appetite for borrowing by the government, which can be linked to better availability of external funding, and the government's decision to remain around the target in PIB auctions.

In terms of the country's fiscal performance, the budget deficit as percent of GDP was slightly higher than the last year's level.[9] The government (federal and provincial combined) was able to contain expenditures growth to only 4.8 percent in H1-FY15, compared with 10.7 percent in H1-FY14, mainly due to a fall in interest payments.[10] Encouragingly, non-interest current expenditures were also controlled, while development expenditures showed a robust growth (**Chapter 4**).

However, revenue collection continued to be a major concern. Total revenue (federal and provincial) grew by only 5.0 percent in H1-FY15, compared with 13.9 percent last year. Even after adjusting for one-off inflows that had increased non-tax receipts in Q1-FY14, revenues showed a deceleration.[11] Although the government introduced several tax measures in the Budget for FY15, FBR revenues increased by only 13.6 percent during H1-FY15, compared with 16.0

[8] It is important to note that SBP cautiously kept the rupee liquidity tight during initial months of the year, to avoid any unnecessary pressures on the exchange rate, among other considerations.
[9] In H1-FY15, fiscal deficit was 2.2 percent of GDP compared to 2.1 percent in H1-FY14.
[10] The interest payments declined by 4.2 percent YoY in H1-FY15, as compared to an increase of 8.2 percent in the same period last year.
[11] In fact decline in non-tax revenues was already expected, as some one-off inflows, which were available last year (including universal service fund and the mark-up from PSEs against the circular debt settlement), were unlikely to recur this year. This is why budget target of non-tax revenues was set at Rs 874 billion for FY15 – less than the actual receipts of Rs 1,002.4 billion last year.

percent in the same period last year.[12] More worryingly, to achieve its revised target of Rs 2,691 billion by fiscal year-end, FBR has to realize revenue growth of 24.2 percent in the second half of FY15 – undoubtedly a challenging task.[13]

This task becomes more complicated due to the decline in fuel prices that may reduce POL-related revenues. The government has tried to compensate for this by increasing the sales tax rate on petroleum products. Tax collection may also benefit from a rise in POL sales. Further, some revenue impact is also expected from regulatory duties recently imposed on imports of a number of items. While these ad hoc measures may lift revenues to some extent, there is a dire need to address structural issues in the tax colleting system.

The sharp fall in international oil prices has positively impacted Pakistan's external sector. It saved over US$ 691 million in the country's oil import bill, which helped reduce the current account deficit in the second quarter (C**hapter 5**).[14] Healthy growth in remittances also remained a vital source of support, as it financed almost 40 percent of the country's import bill during H1-FY15. Further, around 80 percent of the annual remittance target has already been achieved up to March 2015, which suggests that remittances could easily surpass the target for yet another year.

Financing of the current account deficit was easier during the second quarter of FY15. The issuance of Sukuk in the international market was a success: it was oversubscribed and the government was able to mobilize US$ 1.0 billion, which was double the initial target. Moreover, the successful completion of the 5th review of the IMF program resulted in the disbursement of US$ 1.1 billion during Q2-FY15. These inflows pushed up the country's foreign exchange reserves to a comfortable level. As things stand, SBP's liquid reserves cover more than 3-month import of goods, and were more than sufficient to meet end-December 2014 IMF target of SBP's net international reserves (NIR). In the process, the PKR appreciated by 2.1 percent during the second quarter of the year.

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[12] For instance removing exemptions, expanding the scope of withholding tax, increasing rates of different taxes have been announced in the budget. For details, see Box 4.1 in First Quarterly Report 2014-15.

[13] Although growth in tax collection usually increases in the later part of the year, the required growth this year is significantly higher than the average in H2 of last five years.

[14] Pakistan's oil payments have reduced from US$ 3.8 billion in Q2-FY14, to only US$ 3.1 billion in Q2-FY15. The current account deficit for H1-FY15 was US$ 2.4 billion, which was 20.7 percent higher than the same period last year; however, this increase was primarily due to high trade deficit in the first quarter of the year. Trade deficit during H1-FY15 was US$ 9.8 billion, 61 percent of which was incurred in Q1.

Outlook

In our view, some of the key positives in H1-FY15 will continue into the second half of the year, especially in the external sector. Several FX inflows have realized in H2-FY15, including: coalition support fund; proceeds from the further divesture of HBL; receipts from the IMF; and more are expected like disbursements from the ADB, World Bank and other sources. Furthermore, remittances are likely to maintain their robust growth for the rest of the year. While export growth will probably remain modest, the country's import bill will remain comfortable due to lower oil prices and imposition of regulatory duties on a number of items (see **Section 5.3**).

With this comfort in the balance of payments, the exchange rate is expected to remain stable in the second half, which coupled with low fuel prices, will continue to dampen inflationary expectations. SBP projects CPI inflation in the range of 4 to 5 percent for the whole year, compared with the original target of 8 percent.

We expect credit to the private sector to pick up, as sugarcane crushing gains momentum, and reduction in interest rate stimulates credit demand by businesses. Supply side of the credit to the private sector may also improve, as borrowing by the government is likely to be within target, with the availability of funds from external resources.

However, government borrowing for commodity operation may experience some pressure with the procurement drive for wheat. Purchasing wheat at the support price of Rs 1,300 per 40 kg, would lock-in a significant amount of money in wheat finance, unless existing stocks are offloaded. The ability to offload is challenging as a glut-like situation in the international market dampens export prospects, whereas available stocks and a large (expected) crop size, may not allow the government to break-even in the domestic market (**Chapter 2**). Already the outstanding stock of wheat procurement loans stood at Rs 363 billion by end-December 2014.

The full-year budget deficit is expected to remain higher than the target of 4.9 percent of GDP for several reasons: (i) the required growth rate for tax collection during H2-FY15, to achieve the revised target, is high; (ii) interest payments may increase in H2-FY15 with the 6-monthly coupon payments on PIBs in January 2015;[15] (iii) PSDP spending generally remains higher in the second half; and (iv) expenditures on Zarb-e-Azb, and rehabilitation of IDPs cannot be compromised

[15] The interest payments on domestic debt in January 2015 were Rs 208.3 billion (more than 80 percent of which were related to PIBs), compared with Rs 103.8 billion in January 2014.

on. Moreover, pressure from power related subsidies may continue despite a decline in generation cost (due to a reduction in global oil prices). Furthermore, the power sector continues to suffer from high transmission & distribution losses, and persistent shortfall in recoveries – how these costs would be settled at the year-end, remains to be seen.[16]

Finally, GDP growth is likely to remain higher than last year's level. A better wheat crop, on the back of favorable weather conditions and increase in support prices, may compensate for the sluggish performance of *kharif* crops. Construction is set to improve as more PSDP funds are released by the federal and provincial governments. While the challenges faced by LSM may continue, the services sector is likely to maintain last year's growth momentum.

[16] In the past, the government had to step in for the settlement of outstanding payables/receivables of the power sector.

Box 1.1: Decline in Crude oil Prices and Pass through to Domestic Gasoline Prices

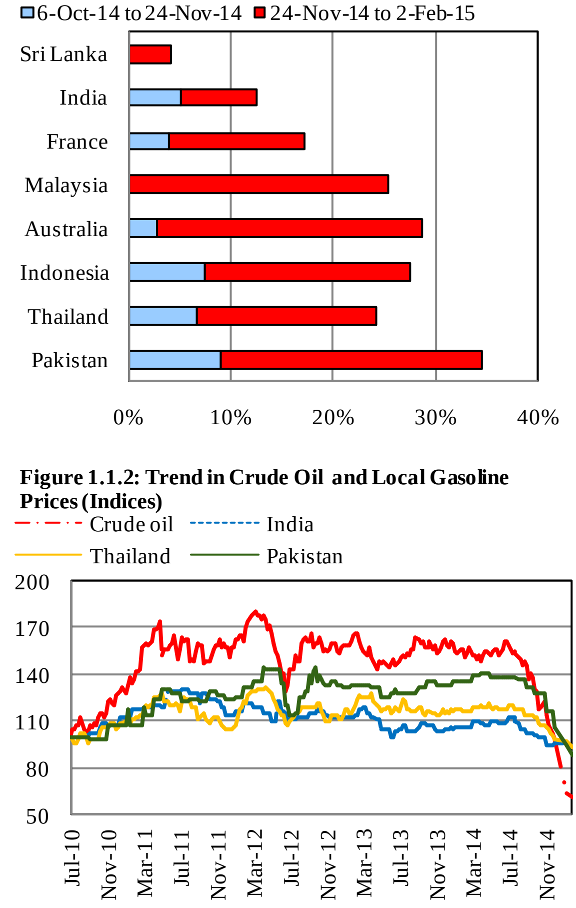
The international oil prices saw a steep decline in H1-FY15, partly on account of weak demand in the global economies, and to some extent, due to substitution to other fossil fuels. In response, countries across the world have been passing on the benefit of lower international oil prices to their end-consumers. The magnitude of this pass through, however, varies across countries, depending upon their economic situation and the mechanism for fuel price determination.

It is clear from **Figure 1.1.1** that during the period from Oct 2014 to Feb 2015, Pakistan has gone beyond many regional economies (and also some advanced countries), in passing-on this relief to domestic consumers even after considering all taxes. In overall terms, the local gasoline prices fell by 34.6 percent during the last four months.[17]

In fact the domestic oil prices in Pakistan follow the global prices more closely, as these are deregulated with a defined pricing mechanism. Interestingly, the historical movements in domestic petroleum prices show a generally higher pass-through as compared to other regional countries, like India and Thailand, also having deregulated pricing mechanism (**Figure 1.1.2**).

Figure 1.1.1: Decline in Local Gasoline Price

Figure 1.1.2: Trend in Crude Oil and Local Gasoline Prices (Indices)



Source: Bloomberg

Although the reduction in domestic fuel prices in Pakistan has adversely affected tax collection, the pass-through will benefit private sectors businesses, which are more efficient. Moreover, this will also help contain inflationary expectations, which is instrumental for macroeconomic stability.

[17] Gasoline prices, which are sourced from www.globalpetrolprices.com, are available from 6th October 2014. The growth in the index of World Crude Oil Prices is calculated from Haver Analytics while of Pakistan from the Pakistan Bureau of Statistics.

2 Real Sector

2.1 Overview

By the end of the second quarter, prospects of a better wheat harvest and the expected recovery in minor crops, are likely to offset the weak performance of FY15 *kharif*. At the same time, the steep decline in oil prices should provide some impetus to growth in large scale manufacturing (LSM). Furthermore, there are signs of robust activity in the construction sector as evident from higher production of cement, steel and paints. In services, though heavyweight sub-sectors, like, *wholesale & retail trade* and *transport, storage & communication* may not be able to achieve their target growth, we expect *finance & insurance* and *general government services* to perform strongly. Thus, in overall terms, real GDP growth is likely to remain slightly higher than the last year.

2.2 Agriculture

Most of the major *kharif* crops performed below expectations in FY15. For example, cotton and sugarcane (together accounting for nearly 40.0 percent of the total value of major crops) missed their production targets (**Table 2.1**),[1] whereas sugarcane could not achieve last year's production level.

Table 2.1: Production Estimates of Kharif Crops

million tons, except for cotton which is in million bales

	FY14		FY15	
	Target	**Actual**	**Targets**	**Estimates**
Rice	6.2	6.8	6.8	6.9
Sugarcane	65.0	67.5	65.5	63.9
Cotton	14.1	12.8	15.1	13.5

Source: Targets are from Annual Plan prepared by the Planning Commission, whereas actual crop size for FY14 and estimates for FY15 are sourced from Pakistan Bureau of Statistics.

In the case of *minor* crops, though we do not have hard numbers, the significant decline in the prices of perishable food items (e.g., potatoes, onion) during the second quarter of FY15, suggests better supplies in the market and lower transportation cost. While a part of the easing in prices could be due to higher imports (and restricted exports) for stabilizing supplies amid flood related losses, preliminary reports from provincial crop reporting centers, suggest a healthier growth in minor crops this year.[2]

[1] For details, see **Chapter 2** of SBP's 1st *Quarterly Report for FY15.*

[2] A better growth in minor crops is also expected due to a low base effect of the previous year; specifically, minor crops had posted a *decline* of 3.5 percent in FY14.

Within *rabi* crops, the Federal Committee on Agriculture has set a target of 26 million tons for this year's wheat crop – around 3 percent higher than the output realized last year.[3,4] Achievement of this target is contingent on improved crop yields from better availability of quality seeds, fertilizer and water, among other factors. The target for area under cultivation, on the other hand, was almost unchanged at last year's level. Perhaps this was in view of expectations that the steep decline in global prices in recent months would discourage farmers from increasing area under cultivation.

Table 2.2: Area under Wheat Crop

000 hectare

	2013-14		2014-15	
	Target	**Actual**	**Target**	**Actual**
Punjab	6,693	6,778	6,600	6,909.9
Sindh	1,100	1,118	1,150	1,108.9
KPK	750	749	760	777.5
Balochistan	400	398	400	383.2
Pakistan	**8,943**	**9,044**	**8,910**	**9,179.5**

Source: Ministry of National Food Security and Research

Specifically, according to the US Department of Agriculture (USDA), wheat prices fell sharply from US$ 334.7 per MT in May 2014 to US$243.7 in September 2014, showing a comfortable supply situation in the global markets.[5] This price decline became an immediate policy concern for the government, as it hits growers' income and their capacity to invest on productivity enhancing technology. The financial difficulties faced by wheat growers increased due to higher input costs.[6] For example, price of DAP rose to Rs 3,800 per 50 kg in Dec 2014 (from Rs 3,430 a year earlier), whereas the price of urea increased from Rs 1,850 per 50 kg to Rs 1,940 during the same period.

Responding to growers' concerns, in early November 2014, the government announced an increase in wheat support price to Rs 1,300 per 40 kg (from Rs

[3] Wheat alone contributes 40 percent of the value of major crops.

[4] The Annual Plan for FY15 had initially fixed the wheat target at 25.8 million tons, which was revised upward to 26 million tons by the Federal Committee on Agriculture in its meeting held on 14th October, 2014.

[5] Not only that the world wheat stock continued to grow for the second consecutive year in 2013-14 (reaching its highest level in over a decade), the recent projections for 2014-15 crop indicate that the global output would even exceed the record production level realized in the previous year.

[6] The cost of wheat production shows an increase over the year on account of higher cost of seeds, fertilizer and electricity. For example, according to estimates prepared by Agriculture Policy Institute, per acre cost of seeds was up by 5 percent; fertilizer cost, which accounted for 1/5th of the overall production cost, increased by 4 percent; and cost of irrigation by private tubewell grew by a substantial 17 percent (probably the extended load shedding compelled farmers to run their tubewell on diesel).

1,250) for the upcoming crop – further widening the gap between domestic wheat prices and those prevailing in global markets. However, due to limited storage capacity and fiscal cost, this requires the government to run down its existing wheat stocks before the arrival of the fresh crop.

Table 2.3: Agri Input Availability (Oct-Dec)

	FY14	FY15
Fertilizer (000 tons)		
Urea	1,702	1,614
DAP	868	832
Water (MAF)	20.6	21.9

Source: Monthly Bulletin on Crop Situation by Suparco

So far, the assessment of wheat production is encouraging. Not only has the area under wheat cultivation improved slightly (**Table 2.2**), the timely availability of water and agri credit are expected to improve yields. More specifically, canal water availability during Oct-Dec FY15 was higher by 6 percent compared to the previous year (**Table 2.3**). Similarly, agriculture credit disbursement remained strong, showing a growth of 37 percent during Q2-FY15 on YoY basis. Production loans continue to account for the bulk of agri credit disbursements (**Table 2.4**).

Table 2.4: Purpose-wise Disbursement of Agri Credit
billion Rupees

	Q2-FY14	Q2-FY15
Production loans	79.4	108.5
Of which		
Crops	39.8	48.7
Livestock & dairy	12.8	12.5
Poultry	17.6	14.7
Developmental loans	9.2	12.9
Of which		
Crops	4.5	3.7
Tractors	2.7	2.2
Livestock & dairy	4	7.1
Grand Total	88.6	121.4

Source: State Bank of Pakistan

As a result, wheat may repeat last year's production of over 25 million tons.[7] Furthermore, the recent rains in Punjab at the growing stage are beneficial, as more water and prolonged low temperature would help raising the crop yield further.

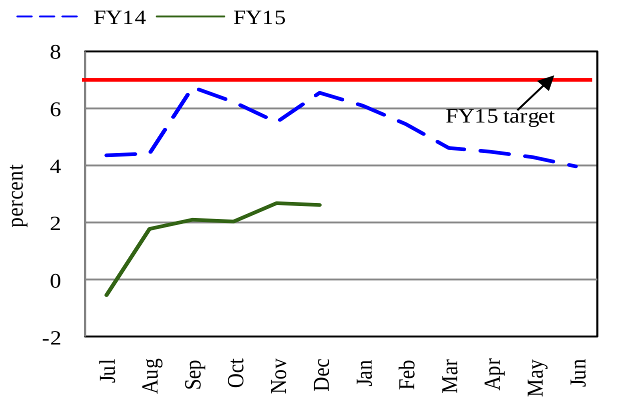
[7] However, the fertilizer off-take during Oct-Dec FY15 declined by 5 percent as compared to the previous year. This was expected given the financial constraints faced by growers as the prices of FY15 *kharif* crops experienced significant decline, and the cost of agri inputs continued to increase persistently.

This large (expected) crop would further add to the surplus wheat in the country.[8] Furthermore, with low export prospects due to excess supply in the global markets, it is feared that government may not be able to offload the surplus wheat before the arrival of the next crop (see **Special Section** at the end of this Report). This not only increases the cost of financing the wheat procurement, there is a risk of wheat losses due to insufficient storage capacity. One way to avoid such situation in future is to strengthen market based instruments (e.g., warehouse receipts, crop insurance, commodity exchange, etc.) for protecting farmers against fluctuations in the market prices.[9]

2.3 Large scale manufacturing

Most of the industries which contributed to slowdown during Q1-FY15 (e.g., fertilizer, cotton yarn, cotton cloth, edible oil, POL, paper, and wood), continued to show weak performance in the second quarter as well.[10] Furthermore, the delay in sugarcane crushing this season caused sugar production during Nov-Dec 2014 to decline to 1.1 million tons from 1.3 million tons in comparable months of 2013.[11] As a result, the overall LSM growth fell sharply to 2.3 percent in H1-FY15, compared to 6.6 percent in the corresponding period of last year (**Figure 2.1** & **Table 2.5**).

Figure 2.1: LSM Growth (Cumulative)



Source:Pakistan Bureau of Statistics

This slowdown in LSM (which is mainly concentrated in agri based industries), more than offset the strong performance by the construction-related industries and automobiles – both benefited from the

[8] The depressed prices in the international market encouraged the private sector to import 0.68 million tons of wheat during Jul-Dec FY15.

[9] Recently, the government has approved the Credit Guarantee Scheme for small farmers who do not have any collateral to offer against loans.

[10] For a detailed discussion on LSM performance during Jul-Sep 2014, see SBP's First Quarterly Report for FY15.

[11] Hence, LSM growth during H1-FY15 improves to 3.45 percent, if we exclude sugar from our sample.

softening global prices of key raw materials (e.g., coal and iron & steel).[12]

Table 2.5: Performance of Large Scale Manufacturing during H1
In percent

		YoY Growth		Percentage Contribution	
	Wt.	**FY14**	**FY15**	**FY14**	**FY15**
LSM Index	70.3	6.6	2.3	100	100
Cotton Yarn	13.0	2.2	0.7	6.6	5.7
Cotton Cloth	7.2	0.8	0.0	1.2	0.2
Fertilizer	4.4	28.8	-1.6	22.8	-4.2
Sugar	3.5	78	-17.5	27.4	-28.7
Vegetable Ghee	1.1	5.4	-0.3	1.2	-0.2
Cooking Oil	2.2	3.7	-0.5	2.3	-0.8
POL	5.5	8.3	2.7	8.2	7.5
Steel	5.4	2.3	31	1.1	40.6
Cement	5.3	1.3	4.4	2.1	19.7
Jeeps and Cars	2.8	2.3	18.5	0.8	17.9
Electronics	2.0	13.5	10.2	3.1	7.0
Paper	2.3	12.7	-2.8	8.0	-5.3
Chemicals	1.7	5.7	6.3	2.1	6.4

Source: Pakistan Bureau of Statistics

Going forward, the manufacturing activity is likely to benefit from a steep decline in global oil prices.[13] Though the immediate gain would accrue to manufacturing units, which rely on oil for their energy needs, other firms would save on transportation and distribution expenses. Even with these gains, the LSM is unlikely to achieve the target growth of 7.1 percent for FY15. This is mainly because (1) the continuing gas shortages are hitting industries such as textiles, paper, leather, glass; (2) the production of sugar may fall this year in line with lower production of sugarcane crop; and (3) fertilizer production which recorded a substantial growth of 16.5 percent in FY14 due to improved gas availability, may not repeat this performance in FY15.

More importantly, the manufacturing sector may not experience any major relief in load management, as according to Nepra report, the power deficit (defined as the difference between peak demand and the generation capability) would remain more than 4,000 MW till 2016-17.[14] The power sector continued to be burdened by serious issues, such as expensive energy mix, high cost of generation, inefficient power plants, weak distribution infrastructure, growing liquidity constraints (mainly due to line losses and unpaid electricity bill), etc.

[12] The production of passenger cars was high also because of the increased demand following the launch of new models by Toyota and Suzuki.
[13] The crude oil prices fell from US$115/ barrel in June 2014 to $50/barrel in January 2015.
[14] In FY14, this gap was 4,406 MW.

Furthermore, Nepra considers the centralized role of Pepco and relevant ministries as the root cause of failure of the power sector.

Sectoral performance

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Weak performance of agro-based industries pulled down LSM growth

<u>Delays in crushing dampened sugar production</u>

Sugar production fell during H1-FY15 mainly due to the late commencement of the sugarcane crushing season following the stand-off between cane growers and sugar mills over support prices. For 2014-15 sugarcane, the Punjab and Sindh governments fixed the support price at Rs 180 and Rs 182 per maund respectively. However, farmers were demanding even higher prices in view of rising cost of production, whereas sugar mills (particularly in Sindh) were reluctant to pay this price in view of large carryover stocks with them. The resulting dispute led to delay in crushing.

To ease financial constraints of sugar mills, government has allowed exports of 0.65 million tons of sugar. More importantly, this export will attract an inland freight subsidy of Rs 2/Kg and a cash subsidy of Rs 8/Kg. In addition, the government has also imposed a regulatory duty of 20 percent on the import of raw and beet sugar.

Mills have already started cane crushing, and we expect sugar production to gain momentum in coming months. The overall sugar production for the full year is, however, likely to remain lower than the last year's level, largely due to a decline in sugarcane crop.[15]

<u>Large inventories from previous year lowered production of edible oil</u>

The ghee manufacturing declined during H1-FY15 primarily in response to large inventories from last year's production. According to industry sources, responding to weak global prices, manufacturers had imported large quantities of palm oil from Indonesia and Malaysia last year, and converted it into edible ghee. Hence, some decline in production was already expected this year.

[15] As mentioned earlier in this chapter, sugarcane crop posted a decline from 67.5 million tons in FY14 to 63.9 million tons during the current season.

Meanwhile, ghee supplies to Afghanistan also remained low, due to availability of cheaper ghee from Iran and central Asian states. This reduced the export demand for our ghee in Afghanistan.

Construction related industries continued to maintain their momentum
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The overall growth in steel production remained strong. In fact, some of the steel manufacturers are expanding their existing capacities, and introducing new product lines. This probably reflects a huge potential for growth as Pakistan still lags behind other countries in the region in terms of per capita steel usage (**Table 2.6**).

Table 2.6: Per Capita Steel Use (in Kg)

	Crude steel	Finished steel products
Pakistan	19.1	15.3
India	63.9	57.8
Sri Lanka	29.8	28
Bangladesh	16.4	15.3
Thailand	291.4	250.6

Source: Steel Statistical Year Book, World Steel Association

In the cement sector, local sales grew by 9.1 percent in the first half of FY15 – the highest level achieved in last five years. Cement demand remained intact owing to ongoing mega construction projects of Metro and Motorways in the northern region of the country. The export quantum however declined mainly due to lower demand from Afghanistan. In contrast, exports to India, and some African countries, continued to show a healthy growth in H1-FY15.

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2.4 Services

The Annual Plan for FY15 envisaged a growth of 5.2 percent for the services sector – significantly higher than the past five-year average growth of 3.6 percent (**Table 2.7**). The Plan envisaged that the revival in agriculture and industry would support a better performance by the services sector.

Table 2.7: Services Sector – Past Performance & Targets
Percent

	Share	Average growth (FY10-14)	FY15 target
Wholesale and retail trade	31.9	2.8	6.1
Transport, storage & communication	22.3	3.2	4.5
Finance & insurance	5.4	1.7	5.8
Housing services	11.6	4.0	4.0
General government services	12.1	9.3	4.3
Other private services	16.6	6.0	5.8
Services		**3.6**	**5.2**

Source: Annual Plan 2014-15, Planning Commission

Table 2.8: Wholesale & retail trade (Jul-Dec)

		FY14	FY15
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FDI in trade	mln US$	-1.5	26.8
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Source: State Bank of Pakistan and Pakistan Bureau of Statistics

While there are signs of strong performance by *finance & insurance* and *general government services*, other sub-sectors, like, *wholesale & retail trade* and *transport, storage &communication* may not be able to achieve their target growth.

The *wholesale and retail trade* (which contributes around one-third of the value addition by services) is likely to miss its target, due to weak performance of the LSM.[19] The expected record wheat crop and a stronger growth in imports would partly compensate for the below target production by the kharif crops and a slowdown in LSM growth (**Table 2.8**).

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addition, despite some improvement, both PIA and Pakistan Railways are expected to post losses in FY15 as well.[20]

Table 2.9: Commercial Vehicles (Jul-Dec)

Growth in percent

	Production		Sales	
	FY14	**FY15**	**FY14**	**FY15**
Trucks	25.2	65.9	39.1	58.5
Buses	2.1	1.7	3.4	-7.6
Light comm. vehicles	29.1	-0.4	17.2	2.8
Other	13.2	1.4	17.8	2.0
Total	**21.3**	**4.5**	**18.4**	**5.9**

Source: Pakistan Bureau of Statistics and Pakistan Automotive Manufacturers Association

The second largest component in this head is the communication. Here, the services providers have started rolling out a range of new products to their customers following the spectrum auction of 3G/4G licenses in April 2014. Firms have been investing in upgrading their systems and network, which is reflected in an increase in foreign direct investment and a surge in telecom imports.[21] As a result, the number of subscribers to 3G/4G services has increased from 1.9 million in Jul 2014, to 7.7 million in Dec 2014.[22, 23]

Government also provided some relief to communication sector in the Federal Budget by reducing the advance income tax on telecom services from the 15 percent to 14 percent, and cutting GST/FED from 19.5 percent to 18.5 percent.[24] Furthermore, the 2015 ICC World Cup could boost revenues of telecom operators as they have offered various products from real-time score updates to live streaming of cricket matches.

The key challenge for the telecom sector is the recent drive by the government to carryout biometric verification of all SIMs in the country. This means all un-verified subscribers will be blocked after the expiry of the deadline. In other

[20] PIA recorded losses of Rs 10.6 billion during Q1-FY15 which was marginally lower than Rs 13.4 billion recorded in Q1-FY14 (this improvement was mainly due to fall in fuel cost). In the case of Pakistan Railways, government has already allocated Rs 37 billion in the federal budget for FY15 to meet expected losses.

[21] Foreign direct investment in telecom during Jul-Dec FY15 increased to US$ 81.9 million against a disinvestment of $ 184.9 million during H1-FY14. In addition, telecom imports during H1-FY15 grew by 21.3 percent on YoY basis, against a *decline* of 27.5 percent during the corresponding period of FY14.

[22] This also includes existing customers who have converted to packages offering high speed data usage.

[23] At the same time, the launch of 3G/4G services is also supporting the broadband services in the country.

[24] This tax reduction is applicable to Islamabad, Balochistan, FATA, AJK and Gilgit Baltistan – these are the regions which have not imposed GST on services.

words, companies will lose some of their customers as a result of this campaign.[25] At the same time, this re-verification drive adds to financial burden of telecom companies. For example, instead of marketing new SIMs, telcos are focusing more on re-verification of existing subscribers; and this required investment to procure devices and systems used in the biometric verification.[26]

The performance of PTCL also remained weak during H1-FY15. Additional cost incurred on voluntary separation scheme brought down the operating profits from Rs 8.6 billion at end-Jun 2014 to Rs 4.5 billion by end of the calendar year 2014.[27]

Within *finance and insurance*, performance of the banking sector improved remarkably during H1-FY15, in terms of growth in asset base, robust earnings and stronger solvency conditions (**Table 2.10**). The asset base of the banks expanded by 8.9 percent during Jul-Dec FY15, as opposed to 4.4 percent in H1-FY14, largely due to government borrowings (mainly in PIBs), policy rate cuts, and lending to the textile, food and energy sector.

Table 2.10: Financial Soundness Indicators

	Jun-13	Dec-13	Jun-14	Sep-14	Dec-14
NPL to total loans (gross)	14.8	13.0	12.8	13.0	12.3
NPL to total loans (net)	4.4	3.1	2.9	3.2	2.7
ROA (before tax)	1.7	1.7	2.1	2.2	2.2
ROE (before tax)	18.5	18.4	23.5	24.2	24.3
Advances to deposits	48.1	48.6	47.7	48.2	48.2

Source: State Bank of Pakistan

With improved credit conditions and more investments in risk-free, high yielding government securities, the pre-tax profits of the banking sector surpassed Rs 134 billion during H1-FY15, showing a robust increase of 119 percent over H1-FY14.[28] As a result, the profitability indicators (e.g., NIM, ROA before tax) showed considerable improvements.

Finally, we expect a higher growth in *general government services* reflecting recent mobilization of resources under operation Zarb-e-Azb against militants groups.

[25] It may be noted that the number of cell phone subscribers has already declined by 0.45 million during Jul-Dec 2014 period.
[26] NADRA is also charging telcos for the verification of the each record, but telcos are recovering this cost from their customers.
[27] PTCL recorded the operating profit of Rs 16 billion for the calendar year 2013.
[28] On full year basis, the banking sector's (pre-tax) profits reached 246 billion rupees in 2014, making it second highest performing sector after oil and gas.

2 Real Sector

2.1 Overview

By the end of the second quarter, prospects of a better wheat harvest and the expected recovery in minor crops, are likely to offset the weak performance of FY15 *kharif*. At the same time, the steep decline in oil prices should provide some impetus to growth in large scale manufacturing (LSM). Furthermore, there are signs of robust activity in the construction sector as evident from higher production of cement, steel and paints. In services, though heavyweight sub-sectors, like, *wholesale & retail trade* and *transport, storage & communication* may not be able to achieve their target growth, we expect *finance & insurance* and *general government services* to perform strongly. Thus, in overall terms, real GDP growth is likely to remain slightly higher than the last year.

2.2 Agriculture

Most of the major *kharif* crops performed below expectations in FY15. For example, cotton and sugarcane (together accounting for nearly 40.0 percent of the total value of major crops) missed their production targets (**Table 2.1**),[1] whereas sugarcane could not achieve last year's production level.

Table 2.1: Production Estimates of Kharif Crops

million tons, except for cotton which is in million bales

	FY14		FY15	
	Target	**Actual**	**Targets**	**Estimates**
Rice	6.2	6.8	6.8	6.9
Sugarcane	65.0	67.5	65.5	63.9
Cotton	14.1	12.8	15.1	13.5

Source: Targets are from Annual Plan prepared by the Planning Commission, whereas actual crop size for FY14 and estimates for FY15 are sourced from Pakistan Bureau of Statistics.

In the case of *minor* crops, though we do not have hard numbers, the significant decline in the prices of perishable food items (e.g., potatoes, onion) during the second quarter of FY15, suggests better supplies in the market and lower transportation cost. While a part of the easing in prices could be due to higher imports (and restricted exports) for stabilizing supplies amid flood related losses, preliminary reports from provincial crop reporting centers, suggest a healthier growth in minor crops this year.[2]

[1] For details, see **Chapter 2** of SBP's 1st *Quarterly Report for FY15.*

[2] A better growth in minor crops is also expected due to a low base effect of the previous year; specifically, minor crops had posted a *decline* of 3.5 percent in FY14.

Within *rabi* crops, the Federal Committee on Agriculture has set a target of 26 million tons for this year's wheat crop – around 3 percent higher than the output realized last year.[3,4] Achievement of this target is contingent on improved crop yields from better availability of quality seeds, fertilizer and water, among other factors. The target for area under cultivation, on the other hand, was almost unchanged at last year's level. Perhaps this was in view of expectations that the steep decline in global prices in recent months would discourage farmers from increasing area under cultivation.

Table 2.2: Area under Wheat Crop

000 hectare

	2013-14		2014-15	
	Target	**Actual**	**Target**	**Actual**
Punjab	6,693	6,778	6,600	6,909.9
Sindh	1,100	1,118	1,150	1,108.9
KPK	750	749	760	777.5
Balochistan	400	398	400	383.2
Pakistan	**8,943**	**9,044**	**8,910**	**9,179.5**

Source: Ministry of National Food Security and Research

Specifically, according to the US Department of Agriculture (USDA), wheat prices fell sharply from US$ 334.7 per MT in May 2014 to US$243.7 in September 2014, showing a comfortable supply situation in the global markets.[5] This price decline became an immediate policy concern for the government, as it hits growers' income and their capacity to invest on productivity enhancing technology. The financial difficulties faced by wheat growers increased due to higher input costs.[6] For example, price of DAP rose to Rs 3,800 per 50 kg in Dec 2014 (from Rs 3,430 a year earlier), whereas the price of urea increased from Rs 1,850 per 50 kg to Rs 1,940 during the same period.

Responding to growers' concerns, in early November 2014, the government announced an increase in wheat support price to Rs 1,300 per 40 kg (from Rs

[3] Wheat alone contributes 40 percent of the value of major crops.
[4] The Annual Plan for FY15 had initially fixed the wheat target at 25.8 million tons, which was revised upward to 26 million tons by the Federal Committee on Agriculture in its meeting held on 14th October, 2014.
[5] Not only that the world wheat stock continued to grow for the second consecutive year in 2013-14 (reaching its highest level in over a decade), the recent projections for 2014-15 crop indicate that the global output would even exceed the record production level realized in the previous year.
[6] The cost of wheat production shows an increase over the year on account of higher cost of seeds, fertilizer and electricity. For example, according to estimates prepared by Agriculture Policy Institute, per acre cost of seeds was up by 5 percent; fertilizer cost, which accounted for 1/5th of the overall production cost, increased by 4 percent; and cost of irrigation by private tubewell grew by a substantial 17 percent (probably the extended load shedding compelled farmers to run their tubewell on diesel).

1,250) for the upcoming crop – further widening the gap between domestic wheat prices and those prevailing in global markets. However, due to limited storage capacity and fiscal cost, this requires the government to run down its existing wheat stocks before the arrival of the fresh crop.

Table 2.3: Agri Input Availability (Oct-Dec)

	FY14	FY15
Fertilizer (000 tons)		
Urea	1,702	1,614
DAP	868	832
Water (MAF)	20.6	21.9

Source: Monthly Bulletin on Crop Situation by Suparco

So far, the assessment of wheat production is encouraging. Not only has the area under wheat cultivation improved slightly (**Table 2.2**), the timely availability of water and agri credit are expected to improve yields. More specifically, canal water availability during Oct-Dec FY15 was higher by 6 percent compared to the previous year (**Table 2.3**). Similarly, agriculture credit disbursement remained strong, showing a growth of 37 percent during Q2-FY15 on YoY basis. Production loans continue to account for the bulk of agri credit disbursements (**Table 2.4**).

Table 2.4: Purpose-wise Disbursement of Agri Credit
billion Rupees

	Q2-FY14	Q2-FY15
Production loans	79.4	108.5
Of which		
Crops	39.8	48.7
Livestock & dairy	12.8	12.5
Poultry	17.6	14.7
Developmental loans	9.2	12.9
Of which		
Crops	4.5	3.7
Tractors	2.7	2.2
Livestock & dairy	4	7.1
Grand Total	88.6	121.4

Source: State Bank of Pakistan

As a result, wheat may repeat last year's production of over 25 million tons.[7] Furthermore, the recent rains in Punjab at the growing stage are beneficial, as more water and prolonged low temperature would help raising the crop yield further.

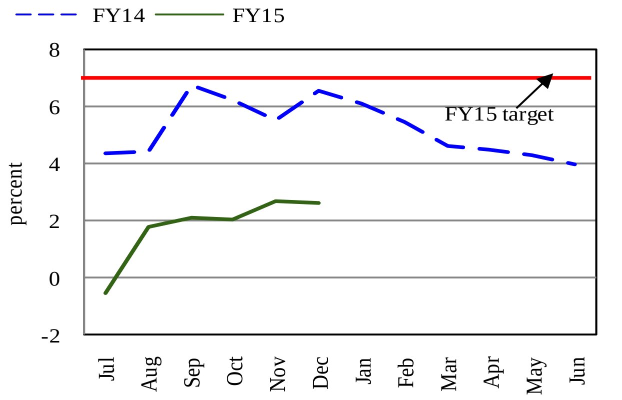
[7] However, the fertilizer off-take during Oct-Dec FY15 declined by 5 percent as compared to the previous year. This was expected given the financial constraints faced by growers as the prices of FY15 *kharif* crops experienced significant decline, and the cost of agri inputs continued to increase persistently.

This large (expected) crop would further add to the surplus wheat in the country.[8] Furthermore, with low export prospects due to excess supply in the global markets, it is feared that government may not be able to offload the surplus wheat before the arrival of the next crop (see **Special Section** at the end of this Report). This not only increases the cost of financing the wheat procurement, there is a risk of wheat losses due to insufficient storage capacity. One way to avoid such situation in future is to strengthen market based instruments (e.g., warehouse receipts, crop insurance, commodity exchange, etc.) for protecting farmers against fluctuations in the market prices.[9]

2.3 Large scale manufacturing

Most of the industries which contributed to slowdown during Q1-FY15 (e.g., fertilizer, cotton yarn, cotton cloth, edible oil, POL, paper, and wood), continued to show weak performance in the second quarter as well.[10] Furthermore, the delay in sugarcane crushing this season caused sugar production during Nov-Dec 2014 to decline to 1.1 million tons from 1.3 million tons in comparable months of 2013.[11] As a result, the overall LSM growth fell sharply to 2.3 percent in H1-FY15, compared to 6.6 percent in the corresponding period of last year (**Figure 2.1** & **Table 2.5**).

Figure 2.1: LSM Growth (Cumulative)



Source:Pakistan Bureau of Statistics

This slowdown in LSM (which is mainly concentrated in agri based industries), more than offset the strong performance by the construction-related industries and automobiles – both benefited from the

[8] The depressed prices in the international market encouraged the private sector to import 0.68 million tons of wheat during Jul-Dec FY15.

[9] Recently, the government has approved the Credit Guarantee Scheme for small farmers who do not have any collateral to offer against loans.

[10] For a detailed discussion on LSM performance during Jul-Sep 2014, see SBP's First Quarterly Report for FY15.

[11] Hence, LSM growth during H1-FY15 improves to 3.45 percent, if we exclude sugar from our sample.

softening global prices of key raw materials (e.g., coal and iron & steel).[12]

Table 2.5: Performance of Large Scale Manufacturing during H1
In percent

		YoY Growth		Percentage Contribution	
	Wt.	**FY14**	**FY15**	**FY14**	**FY15**
LSM Index	70.3	6.6	2.3	100	100
Cotton Yarn	13.0	2.2	0.7	6.6	5.7
Cotton Cloth	7.2	0.8	0.0	1.2	0.2
Fertilizer	4.4	28.8	-1.6	22.8	-4.2
Sugar	3.5	78	-17.5	27.4	-28.7
Vegetable Ghee	1.1	5.4	-0.3	1.2	-0.2
Cooking Oil	2.2	3.7	-0.5	2.3	-0.8
POL	5.5	8.3	2.7	8.2	7.5
Steel	5.4	2.3	31	1.1	40.6
Cement	5.3	1.3	4.4	2.1	19.7
Jeeps and Cars	2.8	2.3	18.5	0.8	17.9
Electronics	2.0	13.5	10.2	3.1	7.0
Paper	2.3	12.7	-2.8	8.0	-5.3
Chemicals	1.7	5.7	6.3	2.1	6.4

Source: Pakistan Bureau of Statistics

Going forward, the manufacturing activity is likely to benefit from a steep decline in global oil prices.[13] Though the immediate gain would accrue to manufacturing units, which rely on oil for their energy needs, other firms would save on transportation and distribution expenses. Even with these gains, the LSM is unlikely to achieve the target growth of 7.1 percent for FY15. This is mainly because (1) the continuing gas shortages are hitting industries such as textiles, paper, leather, glass; (2) the production of sugar may fall this year in line with lower production of sugarcane crop; and (3) fertilizer production which recorded a substantial growth of 16.5 percent in FY14 due to improved gas availability, may not repeat this performance in FY15.

More importantly, the manufacturing sector may not experience any major relief in load management, as according to Nepra report, the power deficit (defined as the difference between peak demand and the generation capability) would remain more than 4,000 MW till 2016-17.[14] The power sector continued to be burdened by serious issues, such as expensive energy mix, high cost of generation, inefficient power plants, weak distribution infrastructure, growing liquidity constraints (mainly due to line losses and unpaid electricity bill), etc.

[12] The production of passenger cars was high also because of the increased demand following the launch of new models by Toyota and Suzuki.
[13] The crude oil prices fell from US$115/ barrel in June 2014 to $50/barrel in January 2015.
[14] In FY14, this gap was 4,406 MW.

Furthermore, Nepra considers the centralized role of Pepco and relevant ministries as the root cause of failure of the power sector.

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Total	**21.3**	**4.5**	**18.4**	**5.9**

Source: Pakistan Bureau of Statistics and Pakistan Automotive Manufacturers Association

The second largest component in this head is the communication. Here, the services providers have started rolling out a range of new products to their customers following the spectrum auction of 3G/4G licenses in April 2014. Firms have been investing in upgrading their systems and network, which is reflected in an increase in foreign direct investment and a surge in telecom imports.[21] As a result, the number of subscribers to 3G/4G services has increased from 1.9 million in Jul 2014, to 7.7 million in Dec 2014.[22, 23]

Government also provided some relief to communication sector in the Federal Budget by reducing the advance income tax on telecom services from the 15 percent to 14 percent, and cutting GST/FED from 19.5 percent to 18.5 percent.[24] Furthermore, the 2015 ICC World Cup could boost revenues of telecom operators as they have offered various products from real-time score updates to live streaming of cricket matches.

The key challenge for the telecom sector is the recent drive by the government to carryout biometric verification of all SIMs in the country. This means all un-verified subscribers will be blocked after the expiry of the deadline. In other

[20] PIA recorded losses of Rs 10.6 billion during Q1-FY15 which was marginally lower than Rs 13.4 billion recorded in Q1-FY14 (this improvement was mainly due to fall in fuel cost). In the case of Pakistan Railways, government has already allocated Rs 37 billion in the federal budget for FY15 to meet expected losses.

[21] Foreign direct investment in telecom during Jul-Dec FY15 increased to US$ 81.9 million against a disinvestment of $ 184.9 million during H1-FY14. In addition, telecom imports during H1-FY15 grew by 21.3 percent on YoY basis, against a *decline* of 27.5 percent during the corresponding period of FY14.

[22] This also includes existing customers who have converted to packages offering high speed data usage.

[23] At the same time, the launch of 3G/4G services is also supporting the broadband services in the country.

[24] This tax reduction is applicable to Islamabad, Balochistan, FATA, AJK and Gilgit Baltistan – these are the regions which have not imposed GST on services.

words, companies will lose some of their customers as a result of this campaign.[25] At the same time, this re-verification drive adds to financial burden of telecom companies. For example, instead of marketing new SIMs, telcos are focusing more on re-verification of existing subscribers; and this required investment to procure devices and systems used in the biometric verification.[26]

The performance of PTCL also remained weak during H1-FY15. Additional cost incurred on voluntary separation scheme brought down the operating profits from Rs 8.6 billion at end-Jun 2014 to Rs 4.5 billion by end of the calendar year 2014.[27]

Within *finance and insurance*, performance of the banking sector improved remarkably during H1-FY15, in terms of growth in asset base, robust earnings and stronger solvency conditions (**Table 2.10**). The asset base of the banks expanded by 8.9 percent during Jul-Dec FY15, as opposed to 4.4 percent in H1-FY14, largely due to government borrowings (mainly in PIBs), policy rate cuts, and lending to the textile, food and energy sector.

Table 2.10: Financial Soundness Indicators

	Jun-13	Dec-13	Jun-14	Sep-14	Dec-14
NPL to total loans (gross)	14.8	13.0	12.8	13.0	12.3
NPL to total loans (net)	4.4	3.1	2.9	3.2	2.7
ROA (before tax)	1.7	1.7	2.1	2.2	2.2
ROE (before tax)	18.5	18.4	23.5	24.2	24.3
Advances to deposits	48.1	48.6	47.7	48.2	48.2

Source: State Bank of Pakistan

With improved credit conditions and more investments in risk-free, high yielding government securities, the pre-tax profits of the banking sector surpassed Rs 134 billion during H1-FY15, showing a robust increase of 119 percent over H1-FY14.[28] As a result, the profitability indicators (e.g., NIM, ROA before tax) showed considerable improvements.

Finally, we expect a higher growth in *general government services* reflecting recent mobilization of resources under operation Zarb-e-Azb against militants groups.

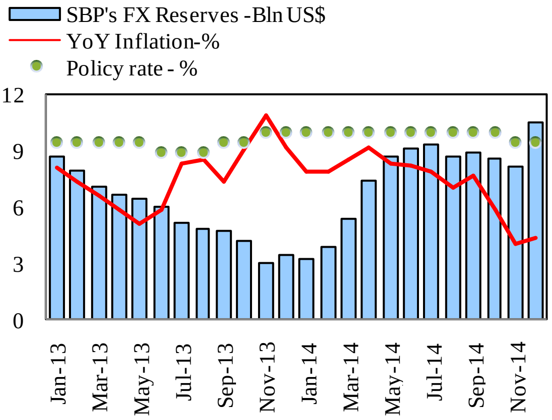
[25] It may be noted that the number of cell phone subscribers has already declined by 0.45 million during Jul-Dec 2014 period.
[26] NADRA is also charging telcos for the verification of the each record, but telcos are recovering this cost from their customers.
[27] PTCL recorded the operating profit of Rs 16 billion for the calendar year 2013.
[28] On full year basis, the banking sector's (pre-tax) profits reached 246 billion rupees in 2014, making it second highest performing sector after oil and gas.

3 Inflation and Monetary Policy

3.1 Overview

The second quarter of the year marked the beginning of monetary easing, as SBP cut the policy rate by 50 bps to 9.5 percent in mid-November 2014 (**Figure 3.1**).[1] This change in monetary policy stance was primarily driven by a visible improvement in both inflation and inflationary outlook; the growing comfort on external front; and some positive developments vis-à-vis the government efforts towards fiscal consolidation.

Figure 3.1: Key Indicators of Policy Environment



Source: State Bank of Pakistan

These developments gained further momentum in subsequent period. Specifically, Pakistan successfully launched a five-year dollar-denominated Sukuk in international market by end-November 2014[2]; the successful completion of the 5th review of the IMF program resulted in the disbursement of US$ 1.1 billion in December 2014; and the current account recorded a surplus of US$ 76.0 million during the month of December 2014, largely due to a contraction in the trade deficit and stronger remittances. These improvements, coupled with a decline in inflation and lower government borrowing from the banking system, allowed the central bank to ease its monetary policy. The policy rate was further cut by a cumulative 150 bps to a ten-year low of 8.0 percent in the monetary policy decisions of January and March 2015.

Prior to the change in policy stance, SBP not only held up the policy rate unchanged during the initial months of the year, but also kept liquidity tight in

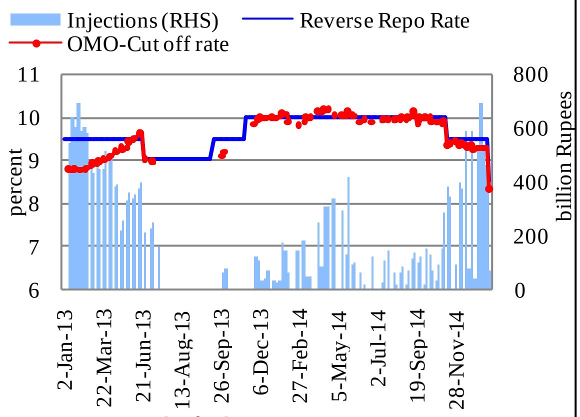
[1] After a cumulative 100 bps increase in the policy rate during Jul-Nov 2013, it was kept unchanged for a full year till November 2014.
[2] Against the target of US$ 500 million, total bids worth US$ 2.3 billion were received.

money market. This was considered necessary to ensure stability in foreign exchange market, and to contain relatively higher non-food inflation.

However, the fall in global oil prices, softening commodity prices, stability in exchange rate, limited impact of floods on food inflation, and lagged impact of monetary tightening, contained inflation.[3] Specifically, inflation declined sharply from September 2014 onwards, and reached a decade-low of 2.5 percent in March 2015.

Among other factors, sharp fall in commodity prices has also impacted bank credit in H1-FY15.[4] So far net credit to the private sector has expanded by Rs 222.3 billion in H1-FY15, compared with Rs 321.3 billion during the same period last year. This, together with lower government borrowing from the banking sector, contained money supply during the period under review. Specifically, broad money supply (M2) grew by only 4.4 percent during H1-FY15, compared with 6.0 percent during the same period last year.

Figure 3.2: Money Market Dynamics



Source: State Bank of Pakistan

3.2 Liquidity conditions

With the comfort on the external front, coupled with the change in monetary policy stance to ensure smooth flow of bank credit to the private sector, SBP stepped up liquidity injections from November 2014 through its open market operations (OMOs) (**Figure 3.2**). The volume of OMOs increased sharply and

[3] It is important to mention here that risks to inflationary outlook dissipated only in the second quarter of the year. Initially it was feared that floods would have a serious impact on the prices of perishable items, while non-food inflation was expected to increase due to planned increase in electricity tariff.

[4] On the one hand, a sharp fall in inflation increased the real cost of borrowing during the period under review: inflation adjusted weighted average lending rate (WALR) during H1-FY15 stood at 5.2 percent, compared with 1.9 percent during the same period last year (the WALR used to calculate the real cost of borrowing does not include zero-markup and inter-bank loans). On the other hand, fall in commodity prices (especially of oil, cotton, and rice) reduced demand for bank credit.

crossed Rs 500 billion in December 2014. The OMO cut-off rate also decreased, as SBP was willing to accept more bids. In this context, following points are worth noting.

1. During 15th Nov-31st Dec 2014, the *acceptance to bid* ratio in OMOs stood at 97.9 percent, compared with 90.7 percent in OMOs held during 1st Jul-14th Nov 2014;
2. Average volume of liquidity injection through OMOs also increased from Rs 94.2 billion during 1st Jul-14th Nov 2014, to Rs 319.3 billion during 15th Nov-31st Dec 2014; and
3. The OMO cut-off rate also reflected SBP willingness to provide liquidity, as it was kept visibly *lower* than the policy rate (**Figure 3.2**).

The above points indicate that overall liquidity was at ease after the change in monetary policy stance. However, despite this improvement, bank-specific liquidity problems continued to persist during the second quarter of the year. Specifically, banks borrowed Rs 1,170.4 billion from SBP in 118 visits during Q2-FY15, against Rs 693.3 billion in 98 visits during Q1-FY15.

3.3 Monetary aggregates

Broad money supply increased by 4.4 percent during H1-FY15, compared with 6.0 percent during the same period last year. This deceleration was primarily due to lower government borrowing and subdued growth in credit to the private sector. These factors helped contain growth in NDA of the banking sector, especially of SBP's NDA (**Table 3.1**).

3.3.1 Net foreign assets (NFA)

NFA of the banking sector saw a net expansion of Rs 47.6 billion during H1-FY15, in sharp contrast to a net contraction of Rs 215.2 billion during the same period last year. Quarterly bifurcation of data indicates that the expansionary impact was entirely concentrated in second quarter of the year: a reflection of visible improvement on the external front.

Within the banking sector, NFA of SBP expanded by Rs 65.4 billion during H1-FY15, against a net contraction of Rs 229.8 billion during the same period last year. This sharp reversal was largely attributed to issuance of a Sukuk bond, and other multilateral inflows (excluding IMF).

On the other hand, NFA of scheduled banks contracted by Rs 17.7 billion during H1-FY15 against the net expansion of Rs 14.6 billion during the same period last year. This contraction stemmed primarily from a rise of US$ 425 million in import financing (against FE-25 deposits) during H1-FY15.[5] Since overall FE-25 deposits increased only by US$ 65 million, commercial banks had to withdraw their placements/balances held abroad to finance these loans. This caused a reduction in their NFA.[6]

Table 3.1: Absolute changes Monetary Aggregates (Jul-Dec)

billion Rupees

	FY14			FY15		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Money Supply (M2)	21.5	506.4	527.9	-6.0	448.8	442.8
NDA	194.6	548.4	743.0	25.0	370.1	395.2
SBP	174.2	161.2	335.5	-67.1	-139.1	-206.1
Commercial Banks	20.4	387.2	407.6	92.1	509.2	601.3
NFA	-173.2	-42.0	-215.2	-31.1	78.7	47.6
SBP	-146.1	-83.7	-229.8	-8.0	73.4	65.4
Commercial Banks	-27.1	41.7	14.6	-23.0	5.3	-17.7

Source: State Bank of Pakistan

3.3.2 Net domestic assets (NDA)

H1-FY15 expansion in NDA of the banking system was almost half the increase seen during the same period last year. The institutional break up shows that sharp deceleration was entirely stemming from a huge contraction of Rs 206.1 billion in the NDA of SBP. This contraction was on cards as the government was required to contain its budgetary borrowing from SBP within the limit agreed with the IMF (under the program) for end December 2014, especially after missing the target for end September 2014.[7] It is encouraging to note that the contraction was large enough to facilitate SBP in meeting the IMF ceiling on its NDA for end December 2014.

[5] The increase in import financing was much larger compared to an overall increase in FE-25 deposits (US$ 65 million) during this period.
[6] Banks' placements/investments abroad are effectively a claim on foreigners (included in NFA), whereas trade financing is a claim on domestic exporters/importers (included in NDA).
[7] IMF ceiling on net budgetary borrowing from SBP for end-December 2014 was Rs 2,000 billion, compared with Rs 2,328 billion for end June 2014. This indicates a net retirement of Rs 328 billion during H1-FY15.

One of the key factors behind net contraction in NDA of SBP was the government efforts to switch its borrowing away from SBP to commercial banks (more on this later). The impact of change in sources of government borrowing was also amply visible from sharp increase in NDA of the commercial banks. Specifically, despite subdued growth in credit expansion, NDA of commercial banks expanded by Rs 601.3 billion during H1-FY15, against an increase of Rs 407.6 billion during the same period last year.

Table 3.2: Net Budgetary Borrowing

billion Rupees

	FY14			FY15		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Banking System	198.0	285.3	483.3	139.9	59.1	199.0
SBP	352.8	90.3	443.1	-39.0	-374.4	-413.4
Scheduled banks	-154.8	195.0	40.1	178.9	433.5	612.4

Source: State Bank of Pakistan

Government borrowing[8]

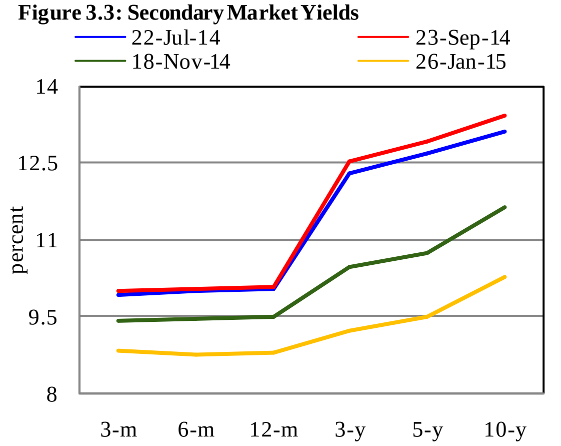
On a positive note, government borrowing from the banking system in H1-FY15 was less than half the amount that government borrowed during the same period last year. Moreover, the government was not only able to meet the limit on its borrowing from central bank under the SBP Act 1956, it was also able to contain its borrowing from SBP within the ceiling agreed with the IMF for end December 2014.[9] Specifically, the government retired Rs 374.4 billion to SBP during second quarter of the year, taking the cumulative retirement to Rs 413.4 billion during H1-FY15. This was almost the mirror image of the pattern of government borrowing from SBP in H1-FY14: an increase of Rs 443.1 billion (**Table 3.2**).

Further details on government borrowing indicate that massive (net) retirement to SBP was partially funded by government borrowing from commercial banks. Specifically, the government borrowed Rs 612.4 billion (in net terms) from commercial banks during first half of the year, compared with only Rs 40.1 billion during the same period last year.

[8] Discussion in this section is based on government borrowing data on cash basis, which will not match with the Monetary Survey data compiled on accrual basis.
[9] It is pertinent to mentioned here that the government missed the IMF ceiling on budgetary borrowing from SBP for end September 2014.

In fact, while the government was switching its borrowing away from SBP to commercial banks in a bid to meet the IMF targets, the commercial banks were also aggressively participating in primary auctions of government securities to lock-in their funds at higher interest rates in anticipation of a cut in the policy rate. Specifically, commercial banks offered Rs 832.9 billion in PIB auctions during Q2-FY15 against the cumulative target of only Rs 150.0 billion.[10] In fact, banks were eager to exploit the disconnect between the short (up to one year) and medium to long end of yields, before the change in monetary policy (**Figure 3.3**).

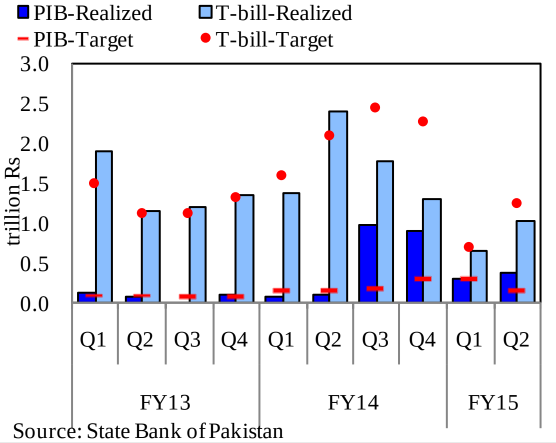
Figure 3.3: Secondary Market Yields



Source: State Bank of Pakistan

For the same reason, T-bills became less attractive: commercial banks offered much less than the target in nearly all the auctions held during this period.[11] In net terms, the government accepted Rs 969.7 billion in these auctions, which was less than the maturing amount (**Figure 3.4**). However, banks' appetite for T-bills has revived as the disconnect between the T-bills and PIB segments of the yield curve vanished following the monetary policy decision of January 2015 (**Figure 3.3**). The swift pass-through of cut in the policy rate to secondary market yield of

Figure 3.4: Auction Profile



Source: State Bank of Pakistan

[10] This allowed the government to realize Rs 372.7 billion from PIB auctions, despite reducing the cut-off rate even before the cut in policy rates.

[11] Against the cumulative target of Rs 1,245 billion, commercial banks offered Rs 1,035.5 billion during Q2-FY15.

government securities is also visible from the yield curves. Data indicates that 50 bps cut in the policy rate in November 2014 was reflected in the yields of MTBs and PIBs, which fell by 49 and 158 bps respectively.[12]

Commodity operations

Being a period of seasonal retirement, loans for commodity operations recorded a net contraction of Rs 25.6 billion during H1-FY15. However, this retirement was substantially lower than the net reduction of Rs 88.5 billion during the same period last year (**Table 3.3**). Within commodity finance, wheat financing showed less retirements during H1-FY15, compared with the same period last year. This was because despite the available stocks with public procurement agencies, private sector imported 0.7 million tons to benefit from lower global prices. Therefore, these agencies were unable to offload their stocks and could not make seasonal retirements to commercial banks (**Chapter 2**). Moreover, higher retirement in the last year was largely attributed to aggressive off loading of wheat stocks by the provincial food departments to stabilize wheat prices, especially in Q2-FY14.

Table 3.3: Loans for commodity operations (Jul-Dec)

billion Rupees

	FY14	FY15
Wheat	-85.3	-23.1
Sugar	-3.0	-2.0
Fertilizer	-0.3	-0.5
Rice	0.0	0.1
Total	-88.5	-25.6

Source: State Bank of Pakistan

In aggregate, outstanding loans for commodity operations stood at Rs 466.8 billion as of end December 2014, compared with Rs 381.2 billion at the same time a year before. Further details indicate that around 50 percent of these loans are backed by commodity stocks, while the rest of the amount is receivables on account of subsidies and sales proceeds. This entails unfavorable implications for fiscal operations. Specifically, receivable subsidies of Rs 186.1 billion are a pending liability of the government, and the potential revaluation losses of hypothecated wheat stocks could also be a burden on scarce fiscal resources. As repeatedly highlighted in SBP’s Annual and Quarterly Reports, timely settlement of such receivables will not only help improve fiscal transparency, but also be cost effective for the government.

[12] It is pertinent to mention here that while short term interest rates were moving in line with the policy rate, long term interest rates fell sharply, in anticipation of a further rate cut.

3.4 Credit to private sector

Credit to private sector recorded a YoY growth of 6.0 percent during H1-FY15 compared with 9.6 percent during the same period last year. Both demand and supply factors contributed to this slowdown. On the supply side, a rise in government borrowing from commercial banks and subdued growth in banks deposit, reduced available funds for the private sector during the period under review. On the demand side, softening commodity prices (especially of cotton, rice and sugarcane), persistent energy shortages, and healthy profitability, curtailed the demand for bank credit. Gross disbursements data also shows that average disbursements (Rs 867 billion) during H1-FY15 remained lower than (Rs 1024 billion) in H1-FY14.

Table 3.4: Changes in credit to private sector (Jul-Dec)
billion Rupees

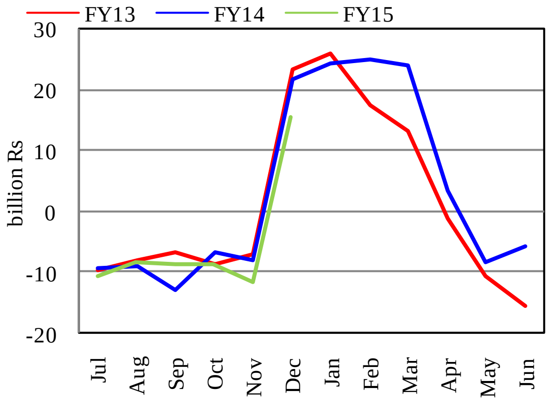
	FY14	FY15
Credit to private sector (MS)	321.3	222.3
of which		
A) Credit to NBFIs	-13.3	-13.0
B) Private sector business	271.8	207.6
of which		
Working Capital	165.4	84.5
Fixed Investment	51.4	36.9
Export Financing	27.6	44.6
Import Financing	27.5	41.5
C) Consumer financing	18.1	11.4
of which		
Personal Loans	13.0	4.9
Auto Loans	5.6	7.4

Source: State Bank of Pakistan; MS: Monetary Survey

Credit demand from private businesses

Within private businesses, the deceleration in credit off take can be traced to lower demand from the manufacturing sector, as the agriculture sector borrowing remained at the level seen in H1-FY14. Specifically, loans to manufacturing sector expanded by Rs 114.6 billion during H1-FY15, compared with an increase of Rs 165.0 billion during the same period last year (**Table 3.5**). This slowdown was largely coming from the food, textile and energy sectors.

Figure 3.5: Credit Cycle of Sugar Industry



Source:State Bank of Pakistan

Textiles: Credit to the textile sector was almost half the increase seen in H1-FY14, as lower cotton prices and a subdued international demand for cotton yarn, contained the working capital requirement. Furthermore, textile industry retired fixed investment loans, which were availed last year to expand and upgrade their capacities to optimize benefits of GSP plus status in the EU.

Table 3.5: Credit to private sector businesses (Jul-Dec)
changes in billion rupees

	Abs. Change		Working capital		Fixed Investment		Trade financing	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector business	271.8	207.6	165.4	84.5	51.4	36.9	55.0	86.1
1) Agriculture	17.1	18.3	13.8	11.1	2.4	7.5	0.9	-0.3
2) Manufacturing	165.0	114.6	96.0	27.1	38.5	19.8	30.5	67.7
Food & beverages	20.9	15.0	2.3	-17.1	10.8	9.5	7.8	22.6
Rice	40.8	26.7	30.0	16.3	0.9	2.0	9.8	8.4
Sugar	-23.9	-31.2	-28.0	-43.9	6.5	12.2	-2.4	0.5
Beverages	3.9	4.7	4.5	-2.9	-0.4	6.2	-0.2	1.4
Edible oil & Ghee	40.8	26.7	1.2	7.5	0.1	-3.8	39.5	23.0
Feeding stuff animals	1.9	7.2	3.7	4.6	0.1	0.1	-1.9	2.4
Textile	100.0	57.7	80.5	34.8	5.6	-1.4	13.9	24.4
Cement	0.4	4.8	-5.2	3.1	6.4	-0.8	-0.9	2.5
Petroleum Products	11.9	14.4	-4.8	7.3	10.3	5.7	6.4	1.3
Basic Metals	8.2	5.7	6.3	-0.1	2.2	-0.9	-0.3	6.6
3) Electricity	31.5	-4.4	22.3	6.5	6.8	-9.5	2.4	-1.4
4) Telecom	-4.6	10.8	1.2	11.5	-6.6	-0.6	0.8	-0.1
5) Others*	86.4	85.2	49.1	27.4	13.4	27.4	23.9	30.5

*Fishing, hotel, transport, education, commerce & trade, construction, mining & quarrying, ship breaking, real estate, health, etc.
Source: State Bank of Pakistan

Food & beverages: loans to food & beverages sector increased by Rs 15.0 billion during H1-FY15, compared with a rise of Rs 20.9 billion during the same period last year. Within food group, major slowdown was seen in the category of loans for rice processing. Given the recent decline in rice prices, the demand for working capital loans was expected to remain subdued.[13]

In line with the typical credit cycle, sugar firms retired bank loans in H1-FY15 (**Figure 3.5**).[14] However, retirements were higher this season as pricing issues delayed cane crushing (**Chapter 2**).[15] In contrast, credit to beverage firms

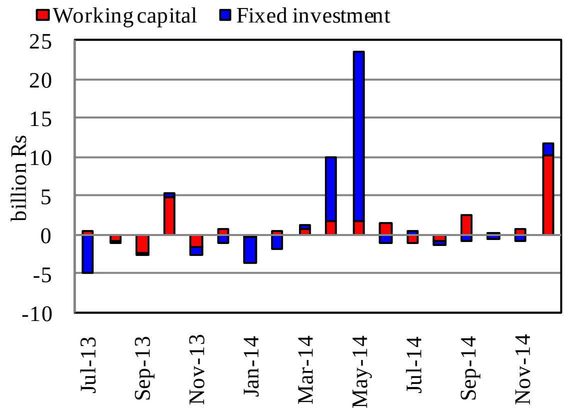
[13] Anecdotal evidences suggests that price of paddy is ranging between Rs 1,500-1,600/40 kg in FY15, compared with Rs 2400-2500/40 kg in FY14.
[14] Sugar industry's credit cycle indicates that the bulk of the retirement takes place during the first quarter of a year, after which credit off-take increases as cane crushing generally starts in early November
[15] Impact of prolonged problem is clearly visible from data on sugar production. Specifically, sugar production in November 2014 stood at 11.6 thousand tonnes, compared with 61.1 thousand tonnes in November 2013.

increased marginally, particularly in the category of fixed investment loans. One of the leading producers is in the process of establishing three green-field production plants.[16]

Energy: electricity-related enterprises retired Rs 4.4 billion during H1-FY15, in contrast with a net expansion of Rs 31.5 billion in H1-FY14. It is important to recall here that government had settled outstanding receivables in the power sector during June and July 2013. As a result, a few private power plants restarted their operations, which generated additional demand for working capital loans in H1-FY14. This impact was missing in H1-FY15. Moreover, smooth settlement of Tariff Differential Subsidies (TDS) by the government, also helped contain liquidity problems of the energy sector.

Telecom: telecom was one of the few sectors in which credit off-take remained higher than last year. Specifically, in contrast to a net retirement of Rs 4.6 billion during H1-FY14, credit to cellular companies expanded by Rs 10.8 billion during H1-FY15. The appetite for working capital loans has increased since the launch of 3G/4G in April 2014 (**Figure 3.6**). Furthermore, this may also reflect purchasing of equipments by cellular firms related to bio-metric verification.

Figure 3.6: Credit Availed by Telecom Sector



Petroleum: credit to petroleum sector expanded by Rs 14.4 billion during H1-FY15, compared with a rise of Rs 11.9 billion during the same period last year. This increase in credit was primarily driven by liquidity requirements of refineries, to finance their day to day production activities.[17] Most importantly, increasing inter-agency receivables and delays in naphtha exports (due to lower price at

[16] Beverages sector has been performing well from the last three years due to rising demand and resultant capacity expansion by firms. FDI inflows to beverage sector stood at US$ 14.2 million during H1-FY15.
[17] Production of petroleum products increased by 2.7 percent during Jul-Dec FY15, compared with 8.3 percent during the same period last year.

international level, refineries followed the policy of wait and see), also created demand for working capital loans.[18]

Deceleration in consumer financing

Consumer financing increased by Rs 11.4 billion during H1-FY15, compared with a rise of Rs 18.1 billion during H1-FY14. Within consumer financing, personal loans saw a deceleration during the period under review, while the auto loans continued to increase. Amendment in regulations for car financing, which allowed banks to finance cars up to 9 years old, and high demand for the new model of Toyota Corolla, seem to be the contributory factors.[19] The deceleration in personal loans is primarily due to high base impact. A number of banks introduced innovative personal loan products, especially designed to cater to the needs of the middle and high income groups in previous years.[20]

3.5 Inflation

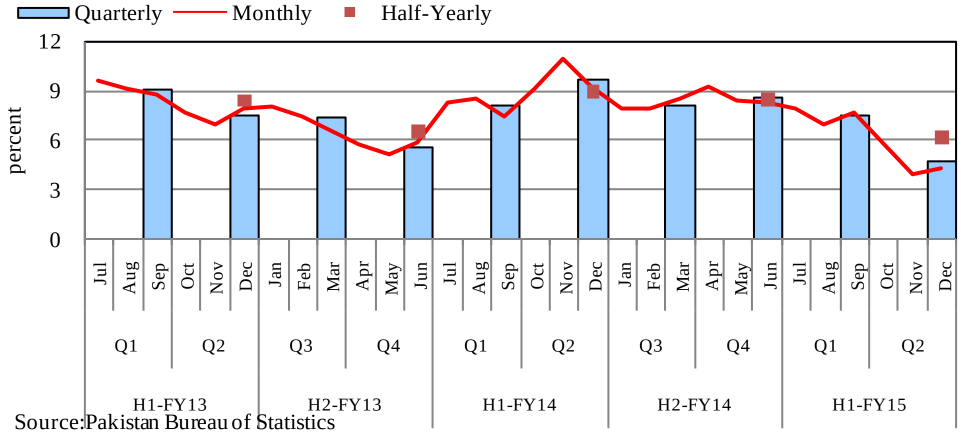
A sharp decline in global oil prices since July 2014, has pushed CPI inflation down to 6.1 percent in H1-FY15, from 8.9 percent during the same period last year (**Figure 3.7)**. This decline was more pronounced in the second quarter of the year, when global oil prices fell more sharply, and the government swiftly passed this on to domestic consumers. In addition, softening global prices of other commodities (like cotton, wheat, edible oil, sugar, etc.);[21] the lagged impact of tight monetary policy prevailed during Jul-2013 to Nov-2014; improved food supplies; and appreciation in the PKR; were among other factors contributing to low inflation during the quarter.

The decline in food and energy inflation had a spill-over impact on other consumer goods, which is evident from a sharp reduction in core inflation – as measure by trimmed mean (**Table 3.6**).[22] NFNE, another measure of the core inflation, also declined during the quarter.

While inflation in all commodity groups declined in recent months, a sharp reduction was seen in *transport* group, which showed a deflation of 1.8 percent in Q2-FY15, compared with an inflation of 6.9 percent in the corresponding period

[18] Exports of naphtha declined by 59.5 percent (in real terms) during Jul-Dec FY15.
[19] BPRD Circular No. 07 of 2014, dated July 23, 2014. According to which, banks/DFIs desirous of financing the purchase of used cars shall prepare uniform guidelines for determining the value of the used vehicles. In no case the bank/DFI shall finance the cars older than nine years.
[20] Cash for Gold, Enhanced-Gold Schemes, etc., are some of the examples.
[21] IMF's Commodity Prices Index (overall) witnessed a more than 20 percent decline during Oct-Dec 2014. Commodity food index declined by 4.8 percent during this period.
[22] Trimmed mean core inflation is computed by excluding highly volatile items from the CPI basket.

Figure 3.7: CPI Inflation (YoY)



Source:Pakistan Bureau of Statistics

last year. However, within the *transport* group, fares of buses and taxi services declined only marginally, in contrast to a sharp reduction in the prices of petrol and diesel (**Figure 3.8**).[23]

Table 3.6: CPI Inflation
(percent)

	Overall	Food	Non-Food	Energy	Core NFNE	Core Trimmed
FY14:						
Q1	8.1	9.1	7.3	1.4	8.5	7.8
Q2	9.7	10.7	9.0	12.2	8.4	9.0
Q3	8.1	8.0	8.2	10.1	7.8	8.2
Q4	8.6	8.2	8.9	10.1	8.6	8.4
FY15:						
Q1	7.5	6.6	8.2	9.1	8.0	7.3
Q2	4.7	3.5	5.5	-2.5	7.1	5.4
H1-FY14	8.9	9.9	8.2	6.8	8.4	8.4
H1-FY15	6.1	5.0	6.8	3.0	7.6	6.4

Source: PBS

Reduction in domestic fuel prices also led to deflation in Administered Price Index – a sub-index of CPI, which declined by 0.2 percent in Q2-FY15, compared with an increase of 11.6 percent in Q2-FY14.[24] Although a few items in this index showed higher inflation than last year (like electricity charges for certain slabs, CNG prices, and motor vehicle tax), these were more than offset by a drastic cut in prices of POL and gas cylinder.

[23] The benefits of low fuel prices to consumers could have been even higher if the provincial governments have timely activated the district-level price control committees for fixing, monitoring and enforcing controls on transport fares and prices of other items. Serious and effective administrative measures are needed under the Price Control and Prevention of Profiteering and Hoarding Act, 1977, to manage prices of essential items.

[24] Administered price index is prepared by SBP's Research Department on the basis of commodity-wise PBS data. It has a weight of 12.22 percent in overall CPI, and includes wheat, sugar, electricity, gas charge, kerosene oil, petrol super, high speed diesel, CNG, Gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.

During Q2-FY15 prices of perishable food items declined significantly due to adequate supply and likely savings in farm-to-market transport cost (**Figure 3.9**).[25] The overall index of perishable food items declined by 1.9 percent in Q2-FY15 – in sharp contrast to Q2-FY14, when this index witnessed an increase of 25.5 percent.

Figure 3.8: Fuel Prices Vs Transport Fares

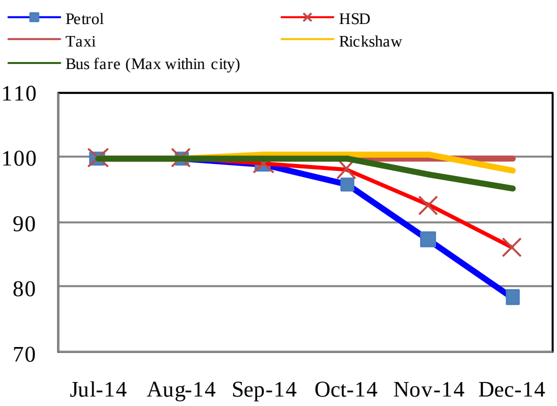
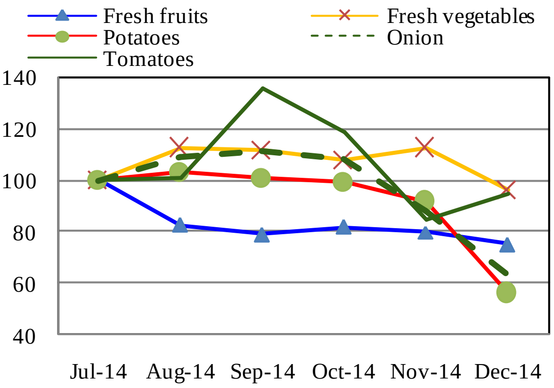


Figure 3.9: Movements in Prices of Perishable Food Items



Inflation expectations

Both POL prices and PKR exchange rate anchor inflation expectations of households and businesses.[26] Successive downward revisions in POL prices and a stable PKR along with subdued global commodity prices are, therefore, expected to keep inflation low in months ahead.

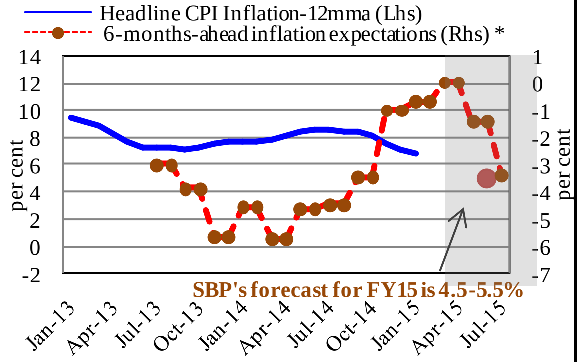
In addition, the survey-based inflation expectations indicator of January 2015, as measured by the IBA-SBP Consumer Confidence Survey (CCS), shows benign inflation expectations. Specifically, the index number measuring the medium-term inflation expectations (6-months-ahead inflation), gauged from one of the survey questions, has recorded an improvement of 1.4 and 3.4 percent in the two consecutive surveys conducted during November 2014 and January 2015, respectively. Similarly, a Financial Market measure of inflation expectations also

[25] Perishable food items include: fresh fruits, potatoes, onion, tomatoes and fresh vegetables.
[26] See Special Section 4.1: The Expectations Channel in Determining Inflation; by Dr. Ali Choudhary and Dr. Mushtaq Khan; SBP Annual Report, FY13, PP 68-70.

improved during last few months, as suggested by a 200 bps fall in long-term interest rates (on 10-years PIBs) since mid-November, 2014.[27]

As shown in **Figure 3.10**, the 6-months-ahead inflation expectations (a measure from IBA-SBP CCS) is one of the leading indicators of the headline CPI inflation. The improvement in both survey-based and market-based inflation expectations measures, coupled with the recent reduction in domestic oil prices, may lead to a sustained fall in CPI inflation in the medium-term.

Fig 3.10: Inflation Expectations vs. Headline CPI Inflation



*: This line shows YoY changes in the moving average of one of the indices of IBA-SBP CCS survey measuring overall inflation expectations for next 6-months.

Nevertheless, how long the inflation will remain at low trajectory will depend upon the behavior of global oil prices going forward. The recent trend of crude oil futures market suggests that the international oil prices have bottomed out, as shown by the upward movement of US$7 in the forward contract from the 6-years low prices of US$ 45.2 witnessed in the last week of January 2015.[28] The International Energy Agency (IEA) has projected that the average oil prices will stay around $55 per barrel in 2015. The future market trends also indicate that the average oil price will stay around US$66 till 2017.

The expected medium-term persistence of the lower international oil prices and some improvement in the energy shortages, might benefit Pakistan's economic growth to some extent in this fiscal year and a year after. Meanwhile, the IBA-SBP Consumer Confidence Index (CCI) also indicates the better economic conditions in the next 6-months as the CCI has recorded an improvement of 12.4 percent from 137.6 to 154.6 in the survey conducted in January 2015 over

[27] While in the survey-based measure of inflation expectations, the respondents are directly asked about the expected inflation, a Financial Market measure of inflation expectations involves inferring medium to long-term inflation expectations from the yield curve. Specifically, money market interest rates on the long-term government bonds reflect a compensation for expected inflation over the time horizon of the bonds, besides showing a reward for postponing current consumption and a liquidity premium.

[28] See http://quotes.ino.com/exchanges/contracts.html?r=NYMEX_CL for detail.

November, 2014.[29] In line with these improved general economic conditions, the respondents of the IBA-SBP Consumer Confidence Survey also consider this time as a good time for making durable goods purchases.

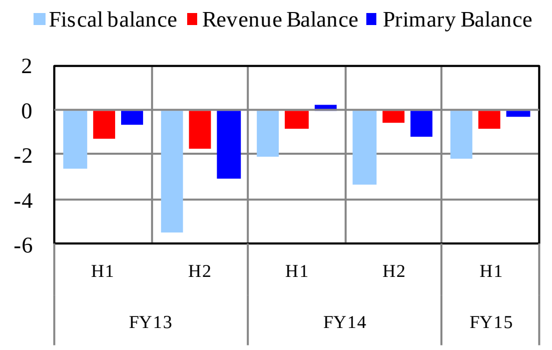
[29] This was the highest level this index has reached since its creation.

4 Fiscal Policy and Public Debt

4.1 Overview

The budget deficit during H1-FY15 was 2.2 percent of GDP – slightly higher than the same period last year (**Figure 4.1**). While some fiscal consolidation efforts are visible in the expenditure side, revenue mobilzation was not upto the mark. Growth in total tax collection (federal and provincial) during H1-FY15 remained lower than the same period last year (**Section 4.2**), despite the introduction of a number of taxation measrues, like removing concessions and exemptions; sending notices to potential tax payers; expanding the scope of withholding tax; and increasing various tax rates.

Figure 4.1: Budget Deficits (Percent of GDP)



Source: Ministry of Finance

On the spending side, growth in total expenditure was 4.8 percent during the first six months of the year, which was less than half the growth witnessed in the same period last year. While the reduction in interest payments was the main factor in containing expenditure, the growth in non-interest expenditure was also lower in H1-FY15, compared with H1-FY14.[1] Encouragingly, the governemnt has controlled current expenditures, while development expenditures have shown a very high growth of 32 percent during this period. Spending on both overall PSDP and BISP, increased significantly in H1-FY15 (**Table 4.1**).

The pattern of financing the fiscal deficit also improved, as reliance on the banking system was reduced, while domestic non-bank and external resources of finance increased. Particularly, the availability of external resources through the issuance of Sukuk (US$ 1.0 billion), and inflows from international financial

[1] Growth in total expenditure, excluding interest payments, was 8.1 percent in H1-FY15, which was about 4 percentage points less than the last year.

institutions, provided much needed support to the financing needs of the government. Moreover, privatization proceeds of Rs 15.2 billion also appears to be used for financing the budget deficit during this period.[2]

Table 4.1: Summary of Fiscal Operations
billion rupees

	Budget FY15	Actual		% Growth	
		H1-FY14	H1-FY15	H1-FY14	H1-FY15
A. Total revenue	4,218	1,665.6	1,749.1	13.9	5.0
Tax revenue	3,344	1,206.9	1,361.1	15.5	12.8
Non-tax revenue	874	458.7	388.0	10.0	-15.4
B. Total expenditure	5,640	2,213.7	2,320.0	10.7	4.8
Current[1]	4,420	1887.6	1,989.0	9.6	5.4
Of which					
Interest payments	1,325	597.7	572.7	8.2	-4.2
Development	1,220	243.5	321.4	-10.5	32.0
PSDP	1,175	212.6	269.4	-15.5	26.7
Other (incl BISP)		30.9	52.0	49.9	68.3
Net lending		82.7	9.6	1360	-88.4
C. Statistical discrepancy		-8.1	80.9		
Fiscal balance (A-B-C)	-1,422	-540.0	-651.8		
Financing					
External sources	508	-43.5	141.5		
Domestic sources	914	583.5	510.4		
Banks	228	483.2	199.1		
SBP	0	443.1	-413.4		
Commercial banks	228	40.1	612.5		
Non-bank	686	100.3	296.1		
Privatization	198		15.2		
% of GDP					
Overall fiscal balance	-4.9	-2.1	-2.2		
Revenue balance	-0.7	-0.9	-0.8		
Primary balance	-0.3	0.2	-0.3		

Source: Ministry of Finance

4.2 Revenues

The growth of total revenue collection (tax plus non-tax) remained modest at 5.0 percent during H1-FY15, compared with 13.9 percent in the same period last year.

[2] However, this amount is very low as compared to the target of Rs 198 billion, set in Federal Budget for FY15 under privatization head.

Within this, tax collection by FBR increased by 13.6 percent during this period, against 16.0 percent in H1 last year (**Table 4.2**). As said earlier, the government introduced a number of measures in the Federal Budget FY15 to increase tax collection, like enhancing the scope of withholding tax, imposition of advance income tax on various transactions, increasing sales tax and FED rates, and making a distinction between filers and non-filers in the application of tax rates.[3] Despite these measures, FBR tax revenues during H1 of the year were short of its half yearly target.

While the decline in international oil prices and resulting reduction in domestic retail fuel prices, adversely affected the tax revenues, but the entire shortfall in revenue cannot be attributed to this factor.[4] The efficiency of tax administration, lack of documentation, and persistent tax leakages, continued to take a toll on tax collection. As per past practice, FBR target for tax collection has been revised downward to Rs 2,691 billion for the year from an original target of Rs 2,810 billion. Even this revised target requires tax collection to increase by 24.2 percent in the second half of the year, which is considerably higher than the average growth in tax collection observed in H2 of the last five years.[5]

Recently, the government has introduced additional tax measures to increase revenues, which include: (i) increase in sales tax rate on POL products from 17 to 27 percent; (ii) imposition of regulatory duty on imports of more than 300 items; (iii) levying a 2 percent withholding tax on non-filers at the time of registering immovable property worth over three million; and (iv) imposition of withholding tax for non-filers in respect of import of goods and services of various items, including iron, iron ore, urea, pulses, ship breaking, etc. While these measures may increase tax collection, to some extent; a broad-based tax reforms program is still needed to address structural issues.[6]

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[3] See SBP First Quarterly Report FY15 for detail of new tax measures.

[4] According to our estimates, the impact of reduced oil prices will be around Rs 100 billion for the whole year (which can vary according to the consumers' demand for POL products). During the second quarter, when fuel prices started declining, the estimated shortfall due to oil prices was not more than Rs 15 billion. However, shortfall in FBR tax collection during H1-FY15 was around Rs 70 billion.

[5] Average YoY growth in tax collection during the second halves of the last five years (i.e., FY10 to FY14) was 15.3 percent. If we exclude one outlier, i.e, FY13 (when growth was just 1.5 percent), the average becomes 18.7 percent. It implies a challenging task for FBR to show a growth of 24.2 percent in H2-FY15.

[6] The government has set up a Tax Reforms Commission, who is currently in the process of preparing its recommendations.

Table 4.2: FBR Tax Collection

billion rupees

	Budget FY15	Actual		% Growth	
		H1-FY14	H1-FY15	H1-FY14	H1-FY15
Direct	1,149	382.0	458.9	15.3	20.1
Indirect	1,661	649.5	713	17.9	9.8
Customs	284	110.1	135.3	2.0	22.9
Sales tax	1,206	481.7	513.8	22.8	6.7
FED	171	57.7	63.9	11.6	10.7
Total taxes	**2,810**	**1031.5**	**1171.9**	**16.0**	**13.6**

Source: Federal Board of Revenue

It is encouraging to note that direct taxes increased by 20.1 percent during H1-FY15 – thanks mainly to increase in the coverage of withholding tax. Some improvement was also seen in the number of tax returns filed by individuals (with a growth of 8 percent), though growth in returns filed by companies remained only 1.2 percent. Moreover, FBR has made efforts to broaden the tax base and strengthen tax compliance by collecting data on financial transactions of prospective taxpayers in terms of purchasing land, insurance policies as well as details of motor registration and international travel. FBR has also issued notices to around 154,000 prospective tax payers and as a result more than 30,000 new tax payers have registered and filed the tax returns.

As expected, non-tax revenues were lower in H1-FY15 than that in H1-FY14 mainly due to the absence of one-offs (like USF and mark up on PSEs loans), which were available last year. The transfer from SBP profit during first half of the year was also lower as compared to the same period last year, though it was in line with the target set for the year (**Table 4.3**). The receipts of CSF (US$ 735 million), however, supported non-tax revenues.

Table 4.3: Non-tax Revenues

billion rupees

	Budget FY15	Actual in H1 FY14	Actual in H1 FY15
Mark-up (PSEs & others)	26	58.4	4.1
Dividends	82	28.3	39.5
SBP profits	270	145.0	137.5
Defence (incl. CSF)	140	38.2	80.2
Royalties on gas & oil	81	36.8	40.9
Passport & other fees	20	7.3	7.2
Discount retained on crude oil	20	8.3	5.4
Windfall levy against crude oil	17	8.0	8.7
Foreign grants	35	12.3	20.6
Other federal	125	67.7	43.8
Of which USF	--	67.6	--
Provincial	58	25.4	24.6
Total nontax revenue	874	**458.7**	**387.9**

Source: Ministry of Finance

4.3 Expenditure

During H1-FY15, total consolidated expenditures of federal and provincial governments grew only by 4.8 percent as compared to an increase of 10.7 percent in the same period last year due mainly to lower interest payments and net lending. Unlike the first quarter of the year, when domestic interest payments increased sharply due to six-monthly coupon payments on PIBs, the second quarter witnessed a negative growth in the interest payments (**Table 4.4**).[7]

Table 4.4: Analysis of Fiscal Spending during H1-FY15
billion Rupees

			% Growth	
	FY14	FY15	FY14	FY15
Current expenditures	**1,887.6**	**1,989.0**	**9.6**	**5.4**
Federal	1,352.8	1,385.7	7.9	2.4
of which				
Interest payment	597.7	572.7	8.2	-4.2
Defense	295.3	329.6	15.1	11.6
Public order and safety	38.7	43.8	15.6	12.9
Others	421.1	439.6	2.6	4.4
Provincial	534.7	603.3	14.2	12.8
Development expenditures	**243.5**	**321.4**	**-10.5**	**32.0**
PSDP	212.6	269.4	-15.5	26.7
Federal	118.6	125.5	-8.1	5.8
Provincial	94.0	143.9	-23.3	53.2
Others (incl BISP)	30.9	52.0	49.9	68.3
Net lending	**82.7**	**9.6**	--	--
Total	**2,213.7**	**2,320.0**	**10.7**	**4.8**

Source: Ministry of Finance

While the change in maturity profile of the government's domestic debt has altered the quarterly pattern of interest payments, to some extent (i.e., more payments falling due in Q1 and Q3), the overall domestic interest payments also contained due to lower interest rates as well as low volume of domestic borrowing. On the other hand, external interest payments picked up as the share of external resources in budgetary financing increased. During H1-FY15, growth in external interest payments was 25.6 percent, compared with -14.0 percent in H1-FY14.

The current expenditure showed a growth of 5.4 percent in H1-FY15, which was significantly lower than the last year. Both the federal and provincial governments remained frugal in their current spending. Even if interest payments are excluded, the growth in the current expenditure was 9.8 percent during this period, compared with 10.3 percent in the last year.

However, development expenditures increased sharply during first half of the year, which is encouraging. Particularly, provincial expenditures on public sector development programs showed a sharp increase of 53.2 percent in H1-FY15, compared with the negative growth (-23.3 percent) in H1 last year. While federal

[7] However, in the third quarter, there can be again a jump with the payment of six-monthly coupon in January 2015.

government's PSDP also increased, its spending on other heads, like BISP, showed a tremendous growth.[8]

4.4 Provincial fiscal operations

The overall provincial surplus reached Rs 143.3 billion by the end of H1-FY15, which is almost half the full year target (i.e., Rs 289 billion). This surplus was 13.0 percent lower than the surplus observed in the first half of the last year. The reduction in provincial surplus was mainly caused by increase in expenditures. Growth in total expenditures (all provinces combined) increased sharply to 18.6 percent in H1-FY15 from 6.1 percent in the same period last year. The share of provinces in consolidated expenditures (federal plus provincial) was 32.5 percent during this period, compared with 28.7 percent last year, while their share in total revenue (including federal transfers) remained almost unchanged. The increase in total expenditures was primarily driven by higher growth in the development expenditures, whereas the current expenditure grew in proportionate to revenues.

On the revenue side, provinces largely remained dependant on federal transfers, while their own efforts resulted in a marginal increase in tax collection during the period. Particularly, Punjab could not boost its own revenue mobilization efforts. In fact, it witnessed YoY declines in property tax, motor vehicle tax, and other taxes (including GST on services) during H1-FY15 – only stamp duties managed to show growth during the period. However, Punjab was the largest recipient of transfers from divisible pool as well federal loans and grants, which helped it show a higher budget surplus, despite aggressive spending on development projects (**Table 4.5**).

Punjab allocated significant amount of resources for construction of roads and other urban development programs (including Rawalpindi-Islamabad Metro Bus Project, having Rs 10.7 billion provision in Punjab Budget 2014-15). It also increased its spending on health and education sectors. On the other hand, the development spending by the Sindh province remained almost at H1-FY14 level, while KPK and Baluchistan also increased their development spending.

Coming again towards revenue, the provinces' own revenue mobilization is around 10 percent of their total revenues despite the fact they have constitutional powers to levy tax on major part of the GDP, i.e., services (which is more than 50 percent of the GDP) and agriculture income (25 percent of the GDP). Provinces

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[8] Rs 43 billion have been disbursed among 4.83 million beneficiaries (families) under BISP during H1-FY15. The government aims to extend its outreach to over 5 million beneficiaries by the close of the current fiscal year. The full year target for BISP is Rs 97.2 billion.

have to develop capacity and make institutional reforms to strengthen revenue mobilization. Currently, different provincial departments have been entrusted to collect tax from various sectors. However, they have varying degrees of efficiency level – the most efficient being the newly established provincial revenue authorities for sales tax on services, which are also using information technologies in their processes.

Table 4.5: Provincial Fiscal Operations during H1

billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
A. Total revenue	349.6	412.5	230.7	249.8	132.5	141.4	87.2	93.2	800.1	897.0
Share in federal revenue	286.5	336.0	179.2	189.7	106.8	118.9	74.0	79.1	646.5	723.7
Taxes	45.0	46.0	36.0	42.3	5.7	5.5	0.9	1.2	87.6	95.0
Non-taxes	14.2	10.8	2.0	3.0	6.5	9.4	2.7	1.4	25.4	24.6
Federal loans & transfers	3.9	19.7	13.5	14.9	13.5	7.5	9.7	11.5	40.6	53.6
B. Total expenditure	295.7	351.4	186.7	208.5	99.7	125.5	53.2	68.3	635.4	753.6
Current	258.4	274.5	149.3	170.6	85.2	104.8	48.5	59.8	541.4	609.8
Development	37.3	76.9	37.4	37.9	14.5	20.6	4.7	8.5	94.0	143.9
Overall balance (A-B)	53.9	61.1	44.0	41.4	32.8	15.9	34.0	24.9	164.7	143.3

Source: Ministry of Finance

4.5 Public debt

Pakistan's public debt recorded an increase of Rs 565.3 billion during H1-FY15, reaching Rs 17.0 trillion as of end-December 2014 (**Table 4.6**). This increase in the public debt was almost half the increase seen during the same period last year. While the domestic debt increased in H1-FY15 by a significantly lower amount compared with the same period last year, the external debt witnessed net retirement during this period, aided by hefty revaluation gains from the appreciation of the US Dollar against other major currencies.

However, despite the slowdown in debt accumulation, Pakistan's public debt is still significantly above the average level of emerging and developing economies.[9]

[9] According to World Economic Outlook (WEO) data, the general government gross debt as percent of GDP for Emerging & Developing economies stood at 40.1 percent, while the same ratio for Pakistan stood at 63.7 percent in FY14.

Domestic debt

The domestic debt increased by Rs 603.2 billion during H1-FY15, compared with Rs 717 billion during the same period last year. The government decision to tap on international debt market, resumption of multilateral inflows, and bilateral arrangements, have helped reduce pressure on domestic sources of funding.

Table 4.6: Pakistan's Public Debt Profile

billion Rupees

	Stock		Flow			
			H1		FY15	
	Jun-14	**Dec-14**	**FY14**	**FY15**	**Q1**	**Q2**
Public Debt	**16,445.2**	**17,010.5**	**1,039.9**	**565.3**	**234.0**	**331.3**
Public domestic debt	11,028.3	11,631.5	717.0	603.2	191.3	412.0
Public external debt	5,417.0	5,379.0	322.9	-37.9	42.8	-80.7
Govt. external debt	4,794.3	4,700.2	326.8	-94.1	33.8	-128.0
Debt from the IMF	298.4	358.4	-55.4	60.0	1.7	58.3
External liabilities	324.2	320.4	51.5	-3.8	7.2	-11.1

Source: State Bank of Pakistan

In addition to some deceleration, the composition of domestic debt also changed. Specifically, the share of permanent debt (medium to long term in nature) has increased to 39.7 percent by end-December 2014, compared with 36.3 percent at the beginning of the year. This increase was attributed to both the government efforts to lengthen the maturity profile of its debt, and the commercial banks aggressive participation in PIBs auctions. In this context, the following points are worth noting:

Table 4.7: Domestic Debt

billion Rupees

	Stock	H1	Stock	H1
	Jun-13	FY14	Jun-14	FY15
T-bills (Auctions)	2,920.2	39.7	1,747.4	64.7
T-bills (SBP)	2,275.2	548.4	2,852.3	-331.0
PIBs	1,321.6	57.9	3,222.0	587.4
NSS	2,006.3	32.3	2,156.2	167.6
Others	1,098.3	38.8	1,050.5	114.6
Total Domestic Debt	**9,621.5**	**717.0**	**11,028.3**	**603.2**

- An exceptionally high term premium between 3-year PIBs and 12-month T-bills, and expectation of decline in the interest rate, attracted commercial banks to lock-in their funds in high yielding PIBs. Commercial banks offered

Rs 1,216.4 billion in six PIBs auctions held during H1-FY15, against the cumulative target of Rs 450 billion: i.e. 2.7 time of the target (Table 4.8).[10]

- During Q2-FY15, commercial banks offered Rs 1,035.5 billion in T-bill auctions against the target of Rs 1,245.0 billion. The government accepted Rs 969.7 billion (competitive bids) in these auction, which was lower than the maturing amount of Rs 978.9 billion during the period under review (**Table 4.9**). It means, the commercial banks were not too keen to invest in T-bills.

Table 4.8: PIBs Auction Profile (Face Value)

billion rupees

	Target	Offer (All)	Accepted (Competitive)	Accepted (All)
Jul	100	82.1	58.22	63.33
Aug	100	93.8	86.8	89.82
Sep	100	207.6	157	160.43
Q1-FY15	**300**	**383.5**	**302.02**	**313.58**
Oct	50	338.7	50.3	57.27
Nov	50	157.8	141.7	144.72
Dec	50	336.4	148.3	152.27
Q2-FY15	**150**	**832.9**	**340.3**	**353.81**

Source: State Bank of Pakistan

Table 4.9: T-bills Auction Profile (Face Value)

billion rupees

			Competitive bids	
	Target	**Maturity**	**offer**	**Accepted**
Jul	225	190.1	254.6	253.6
Aug	225	180.4	163.4	163.1
Sep	250	259.6	201.6	200.6
Q1-FY15	**700**	**630.1**	**619.6**	**617.3**
Oct	550	482.7	351.7	349.3
Nov	520	399	504.5	498.8
Dec	175	97.1	179.3	121.6
Q2-FY15	**1,245**	**978.9**	**1,035.5**	**969.7**

Source: State Bank of Pakistan

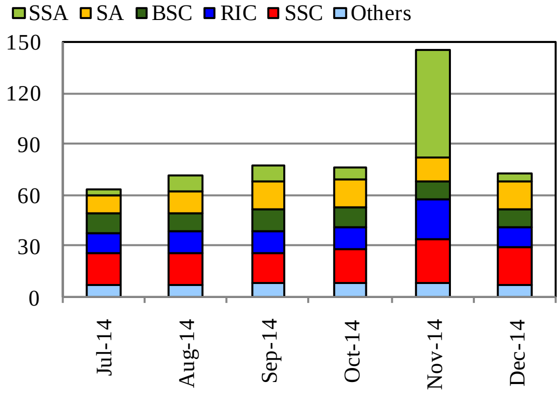
The above developments not only helped improving maturity profile of the domestic debt, but also shifting government borrowing away from SBP. The improvement in the maturity profile of debt would help reduce re-pricing and roll-over risks. However, the benefits of this transformation, especially before the decline in interest rates, should be discounted by the increase in the cost of debt servicing, in the medium to long run.

Contrary to the borrowing from the banking sector, the mobilization of domestic debt from the non bank sector, mainly through National Savings Scheme (NSS), showed a sharp increase during H1-FY15. Net receipts in NSS posted a 7.8 percent growth during this period, compared with 1.6 percent in the same period

[10] However, the term premium declined in December 2014, following the change in monetary policy stance in November, 2014.

last year. The growth in NSS was mainly supported by 63.7 billion inflows in Special Saving Account in November 2014 (**Figure 4.2**). Among other factors, this exceptional increase reflects institutional investment on the expectation of potential cut in profit rate following the reduction in policy rate in November 2014, and decline in PIB yields.[11]

Figure 4.2: Gross Inflows in NSS (billion rupees)



Source: Central Directorate of National Savings

External debt & liabilities

Pakistan's public external debt and liabilities saw a net reduction of US$ 1.3 billion during the first half of year to US$ 53.5 billion by end December 2014 (**Table 4.10**). Quarterly data indicates that the reduction was entirely concentrated during first quarter of the year, while an increase was witnessed in the second quarter. Although the government received external inflows from IMF, international debt market, and other sources during the period under review, the impact of these inflows was more than offset by US$ 3.1 billion revaluation gains from the appreciation of the US Dollar against major currencies.

Table 4.10: External Debt

million US Dollar

	Stock Jun-13	Flow H1-FY14	Stock Jun-14	Flow – FY15		
				Q1	Q2	H1
Public debt & liabilities	50,989.1	-112.0	54,822.7	-,1635.3	357.2	-1,278.0
Government debt	43,496.1	390.6	48,521.1	-1,486.3	-247.7	-1,734.0
From IMF	4,387.0	-797.0	3,020.2	-96.8	644.6	547.8
Foreign exchange liabilities	3,106.0	294.0	3,281.4	-52.2	-39.7	-91.9

Source: State Bank of Pakistan

While main sources of external inflows during were IMF (US$ 1.1 billion) and Sukuk issued in the international market (US$ 1.0 billion), inflows from other creditors during H1-FY15 include: US$ 457.6 million from China mostly for

[11] Following 50 bps cut in policy rate in November 2014, the government revised downward profit rate on NSS in December 2014.

power sector projects;[12] US$ 86.3 million from ADB for *Social Protection Development*; US$ 70.7 million also from ADB for *Flood Emergency Reconstruction* project; and US$ 793.8 million from IDB as a short term loan based on Murabaha arrangement.

[12] Of total amount disbursed, US$ 242.8 million were on account of *GCL Karachi Nuclear Power K2/K3 project* and US$ 74.5 million for *Neelum Jehlum Hydro power project*

5 External Sector

5.1 Overview

After a challenging first quarter, the second quarter of FY15 was quite easy for Pakistan's external sector (**Table 5.1**). On the one hand, the sharp fall in international oil prices reduced the country's import bill, and on the other, EFF disbursements from the IMF resumed after 5th review of the program. Meanwhile, the government was able to mobilize US$ 1.0 billion via Sukuk issuance in the international market.

Table 5.1: External Sector Indicators

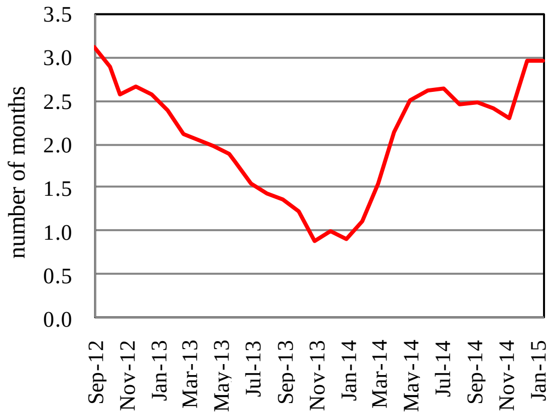
million US$; PKR trend in percent (+app/-dep)

	Q1		Q2		H1	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
PKR trend	-6.0	-3.7	0.7	2.1	-5.4	-1.7
SBP reserves (change)	-1,315	-154	-1,214	1,570	-2,529	1,416
Total reserves (change)	-1,203	-630	-1,503	1,757	-2,706	1,127
C/A balance	-1,315	-1,647	-688	-770	-2,003	-2,417
FDI in Pakistan	240	153	206	371	446	524
IMF loans net	-308	36	-583	718	-891	754
Other loans net	-110	455	33	37	-77	492

Source: State Bank of Pakistan

As a result, the PKR posted an appreciation of 2.1 percent vis-à-vis the US Dollar during the quarter, and the country's FX reserves reached US$ 15 billion by end-December 2014.[1] More importantly, SBP's liquid reserves were equivalent to 3-month of import of goods (**Figure 5.1**) – the first time after September 2012.[2] As a result, net international

Figure 5.1: SBP Reserves as Months of Import of Goods



Source: State Bank of Pakistan

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[1] This appreciation of the PKR was despite SBP's net FX purchases of the US Dollar from the interbank; and mainly represents improved sentiments in the FX market. The Real Effective Exchange Rate (REER) during Q2-FY15 posted an appreciation of 4.5 percent.

[2] 3-month of import cover is an international benchmark for reserves adequacy. Figure 5.1 basically shows months of import of goods, which the available gross SBP liquid reserves can cover.

reserves (NIR) successfully met the end-December IMF target.[3]

The decline in international oil prices is the single-most important development improving the country's BoP outlook.[4] This decline has already lowered Pakistan's import bill by approximately US$ 1.3 billion;[5] and if prices stay where they are (which is to be expected), Pakistan can save up to US$ 2.5 billion *more* in Mar-Jun 2015.[6] The services account should also gain from low freight expenses going forward. Furthermore, this account has also benefited from CSF inflows worth US$ 1.5 billion so far in FY15. The good news is that despite the oil slump, the GCC is still spending on infrastructure, and there are no short-term concerns for remittances inflows into Pakistan from this region. As the FX buffer improves gradually, IMF's upcoming performance reviews are expected to be easier, which would bring another US$ 1.1 billion before June.[7] Inflows (gross) from multilateral and bilateral sources are also expected to the tune of $2.6 billion, and the HBL divesture is likely to mobilize US$ 764 million more (**Section 5.3**).

In the *medium-term*, concerns remain, even if we assume the oil price slump to continue. The key challenge is the continuous weakening of the Euro Area, which constitutes over a quarter of Pakistan's export market. Ironically, this was the region that recently pushed the country's exports vis-a-vis the GSP plus status given to Pakistan. But the Europe continues to suffer from a stagnating economy, tumbling inflation and more recently, fears of deflation. The ECB does not have much left in its policy tool-kit, and all eyes are on how President Draghi's perceived gamble on the QE unfolds.[8] The other important market, the US, is growing well; however, Pakistan's prospects are challenged here with a successful

[3] The IMF defines net international reserves (NIR) as the US Dollar value of the difference between gross international reserve assets and reserve related liabilities, evaluated at the program exchange rates.

[4] Since the beginning of FY15, price of Saudi Arabian Light has come down by over 60 percent.

[5] Petroleum imports have declined by US$ 1.8 billion YoY in Jul-Feb FY15. Of this, there was a negative price impact of US$ 1.3 billion, and a negative quantum impact of US$ 435 million.

[6] If Pakistan imports the *same* quantity of POL in Mar-Jun 2015, which it did in the same period last year, then applying the average unit prices we paid in February (i.e., $400 per MT), Pakistan can save up to US$ 2.5 billion on its import (YoY). However, it remains to be seen how much impact the reduced prices would have on oil consumption. On aggregate, petroleum bill saw a reduction of US$ 116.5 million in February 2015, compared to the preceding month, and US$ 541.6 million compared to February 2014.

[7] The sixth review was completed successfully in February and, following the Board approval in March, US$ 498.3 million was disbursed.

[8] Critics of the ECB's asset purchase program (at least €1.1 trillion) believe that the QE would trigger high inflation and excessive sovereign debt in the EU; and this would outweigh benefits of the program. Among the major critics of this program is Bundesbank's President Jens Weidmann, who had even voted against the move in the ECB's governing council.

negotiation of the Trans-Pacific Partnership (TPP).[9] In plain terms, this agreement would allow major competitors like Vietnam to export garments and footwear to the US at zero tariffs. Already Pakistani exporters are losing ground in this market due to less focus on synthetic textiles.

Another concern comes from the Gulf. So far, it appears that the GCC governments' spending plans have not been impacted by oil prices – thanks to the available sovereign funds at their disposal. However, this cannot go on much longer. A continuous depletion of these reserves would eventually start biting into their fiscal spending, if oil prices fail to recover. The pace of Pakistan's remittance growth cannot remain immune to the oil slump indefinitely. Finally, FX debt repayments loom large a few years down the road: restructured Paris Club installments will begin from FY17, a year after which, the first of the EFF repayments would fall due. Honoring these repayments would require comparable stream of FX earnings, or else, a drawdown of the country's FX reserves is likely.

In this context, we should take the oil price collapse as a short-term breather, which Pakistan must use to correct its chronic BoP imbalances. Importantly, the reduced oil prices must *not* be seen as an opportunity to import consumer items into the country. Instead, the government must think along the lines of what oil exporting countries did in times of high oil prices, i.e., creating reserves. In this context, the government's recent decision to impose regulatory duty on the import of luxurious items, can be helpful in containing imports. More needs to be done. There is a dire need to curb smuggling of goods into the domestic market, to allow local industry to flourish, and also to tap informal FX inflows. Also, Pakistan must be very careful in signing foreign trade agreements (FTAs) with other countries: new FTAs must be thought-out and existing FTAs should get critically reviewed. More specifically, instead of opening up its market to low-technology products (like light engineering items, low-tech electronics, rubber and plastic materials, etc.) from its trading partners at minimal tariffs, Pakistan should incentivize its local industry to substitute for such imports.

Finally, export expansion is a must. We need to go deeper into structural factors that are constraining our potential: reassess the country's resource base; develop an industrial vision; pick winning sectors; design a strategy to lift them, and then stick to it. Efforts are required at a micro level to diversify products; diversify

[9] The Trans-Pacific Partnership (TPP) is a proposed regional regulatory and investment treaty. So far, twelve countries throughout the Asia-Pacific region have participated in negotiations on the TPP including Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam.

markets; and overhaul the supply chain. This is not possible without coordinated policies on the industrial, trade, financial and education fronts; Pakistan would continue to lose its share in the global export market, if key parameters like technology transfers, R&D, and productivity continue to be neglected.

Table 5.2: Current Account
million US$

	Q1			Q2			H1		
	FY14	FY15	Growth	FY14	FY15	Growth	FY14	FY15	Growth
Current account	-1,315	-1,647	25.2	-688	-770	11.9	-2,003	-2,417	20.7
a. Trade account	-4,384	-6,022	37.4	-4,266	-3,805	-10.8	-8,650	-9,827	13.6
Export receipts	6,257	5,960	-4.7	6,210	6,227	0.3	12,467	12,187	-2.2
Cotton yarn	561	445	-20.7	565	429	-24.1	1,127	874	-22.4
Other textiles	2,902	3,020	4.1	2,850	2,905	1.9	5,752	5,926	3.0
Non-textiles	2,794	2,496	-10.7	2,795	2,899	4.7	5,589	5,388	-3.0
Import payments	10,641	11,982	12.6	10,476	10,032	-4.2	21,117	22,014	4.2
POL	3,948	4,476	13.4	3,803	3,112	-18.2	7,751	7,588	-2.1
Non-POL	6,688	7,506	12.2	6,670	6,860	2.8	13,358	14,426	7.5
Metal	713	832	16.8	595	773	30.0	1,307	1,606	22.8
Machinery	1,291	1,358	5.2	1,256	1,341	6.8	2,546	2,698	6.0
b. Services	-906	-505	-44.3	-601	-799	32.9	-1,508	-1,304	-13.5
CSF	0	735	100.0	322	0	-100.0	322	735	128.3
c. Primary income	-822	-812	-1.2	-1,184	-1,480	25.0	-2,006	-2,292	14.3
Repatriation-FDI	-537	-530	-1.3	-795	-1,027	29.2	-1,332	-1,557	16.9
Interest	-181	-187	3.3	-244	-177	-27.5	-425	-364	-14.4
d. Secondary income	4,798	5,692	18.6	5,363	5,314	-0.9	10,161	11,006	8.3
Remittances	3,929	4,695	19.5	3,863	4,287	11.0	7,792	8,982	15.3
Current a/c (exc. CSF)	-1,315	-2,382	81.1	-1,010	-770	-23.8	-2,325	-3,152	35.6

Source: State Bank of Pakistan

5.2 Current account

The current account posted a deficit of US$ 2.4 billion in H1-FY15, an increase of 20.7 percent over the same period last year (**Table 5.2**).[10] This deterioration was more pronounced in the first quarter: in the second quarter, the current account

[10] The situation has changed substantially in subsequent months. The current account posted a marginal deficit of US$ 74 million in January 2015, and a hefty surplus of US$ 877 million in February 2015. As a result, the current account deficit in Jul-Feb FY15 stands at only US$ 1.6 billion, compared to US$ 2.5 billion in Jul-Feb FY14.

shows a much reduced deficit once the impact of CSF inflows is taken out.[11] This improvement came primarily from a reduced trade deficit, as POL import payments fell sharply on account of low prices. Most notably, the current account posted a surplus of US$ 79 million in the month of December.

Services balance posted an improvement in H1-FY15 over last year, primarily on the back of higher CSF inflows in the first quarter. The CSF tranche expected in the second quarter was delayed; a lumpy payment came later in February 2015.[12] Some support to this account should also come from lower freight expenses, as shipping companies have apparently started passing on the impact of cheaper oil to their customers.[13]

Worker remittances have appeared as a major savior for the current account in the previous few years, covering up around 90 percent of the trade deficit. This year, remittances picked up pace and grew by another 15.3 percent YoY during Jul-Dec 2014; this was in comparison to a targeted growth of 5.7 percent for the full-year.[14] Most of the increase came from GCC countries mainly Saudi Arabia and the UAE that are spending heavily on public infrastructure.[15] Since these countries have accumulated large volume of FX reserves in previous few years, it appears that the recent oil slump would not affect governments' spending for some time in the region (**Figure 5.2**).[16] Meanwhile in Pakistan, the government has

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[11] In Q2-FY14, there was an inflow of US$ 322 million under the CSF. In Q2-FY15, no such inflows were recorded.

[12] As per the IMF projections, US$ 240 million were expected each in the second, third and fourth quarters of FY15. No inflows came in the second quarter (compared to US$ 322 million in Q2-FY14), however in February 2015, there was an inflow of US$ 717 million under the CSF.

[13] Freight contributes nearly 95 percent of the country's services deficit, and the balance depends heavily on oil prices and import values.

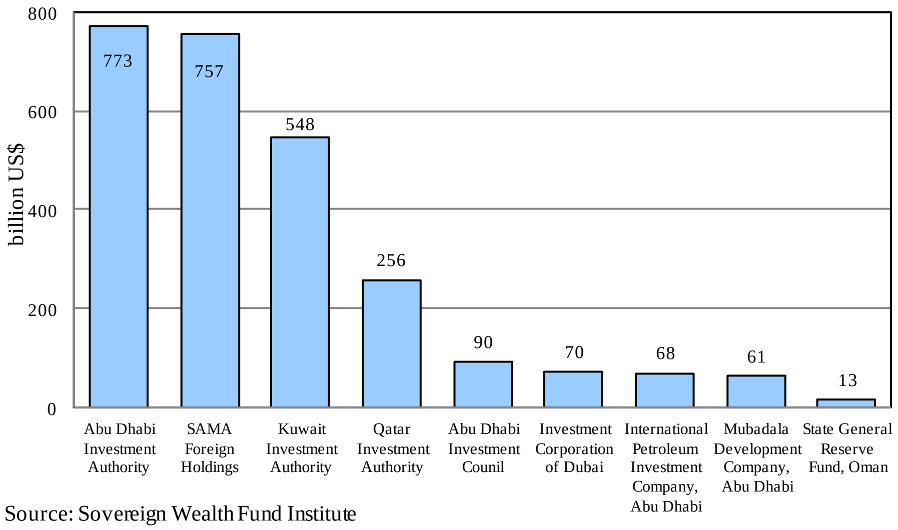
[14] In the Annual Plan for 2014-15, the government has set the target of US$ 16.7 billion against the actual remittances of US$ 15.8 billion last year.

[15] A large number of Pakistanis in the GCC work in construction related activities like labors, masons, carpenters, etc. (source: Bureau of Emigration and Overseas Employment).

[16] Most of the GCC countries have shrugged off oil price concerns while preparing budgets for the next year. For instance, the Saudi government has envisaged a spending *increase* of 0.6 percent for the Budget 2015. This will be the first deficit after 2011, which will be comfortably financed using net foreign assets of the Saudi Arabian Monetary Agency (SAMA). For the UAE, Expo 2020 is generating economic activities: efforts are underway to develop Dubai as a transportation and tourism hub, helped by major infrastructure projects and private investment in hotels, resorts and convention centers. As far as Qatar is concerned, it is preparing to host the 2022 soccer world cup, for which it has significantly increased infrastructure spending. For 2014-16, a robust economic growth is expected fueled by non-hydrocarbon activities in the country. Finally, the Sultanate of Oman has announced an increase in spending for 2015, at the cost of incurring a budget deficit. Like other gulf states, Oman has also been spending heavily on infrastructure and industrial projects after the 2011 Arab Spring uprising, and has also scaled up its social spending since then. The year 2015

further tightened up the anti-money laundering laws, which may help redirect *more* funds into the formal channels.

Figure 5.2: Asset Size of Sovereign Wealth Funds of the GCC (April 2015)



Source: Sovereign Wealth Fund Institute

5.3 Capital and financial account

After a spell of slow activity in the first quarter, financial account witnessed some improvement in Q2-FY15. This improvement stemmed mainly from the issuance of sovereign Sukuk in t he international market; Chinese investment in Pakistan's telecom sector for network up-gradation;[17] and higher FX inflows from the international financial institutions (IFIs).

Other than the telecom, the activity in FDI remained dull. Only power generation, automobile and banking sectors were able to mobilize slightly higher inflows than last year. As far as portfolio investment is concerned, the government is tapping most of the inflows. Not only has it issued Sukuk in the international market, the process of privatizing state owned entities (SOEs) is also underway: HBL's divesture is on cards, and it is expected that the government would be able to mobilize US$ 450 million (FX) in H2-FY15.

would see planned expansion of major airports in Muscat and Salalah, and a US$ 12 billion national railway project.

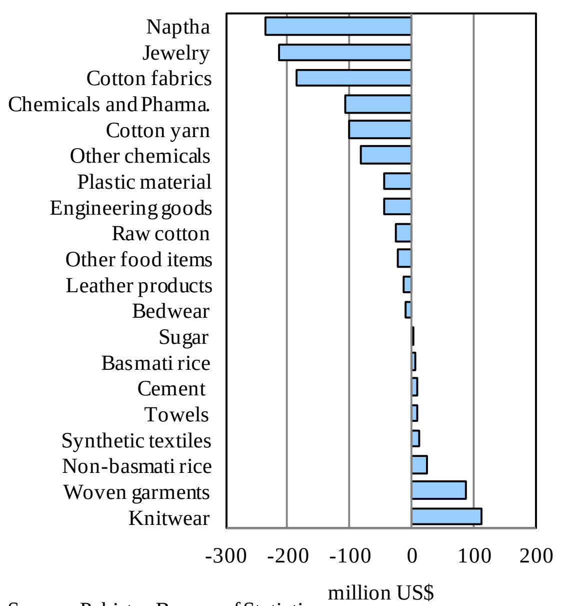
[17] China Mobile Company injected US$ 168 million in its subsidiary in Pakistan, China Mobile Pakistan (CMPak - Zong) for network up-gradation to provide its customers 3G/4G data services.

The government was also able to increase FX borrowings in the second quarter, mainly on the back of higher disbursements from the IDB. However, a part of this was offset by retirement of FX loans by PIA and other non-government agencies. Going forward, disbursements of US$ 2.6 billion more are expected from IFIs and bilateral sources in the remaining part of the year.[18]

5.4 Trade account[19]

The trade deficit posted 33.7 percent increase in H1-FY15, compared to a decline of 8.5 percent in the same period last year. This higher deficit was caused primarily by a sharp rise in the country's imports, as exports declined by 4.4 percent. Interestingly, imports grew by almost 11.5 percent YoY in *both* the quarters of the year: while petroleum dominated Q1 imports, non-petroleum products pushed up the Q2 import bill. In effect, the rise in import of metal, machinery and palm oil in Q2, more than offset the impact of lower petroleum prices during this quarter.[20] As far as exports are concerned, these recovered in the second quarter, after having declined by 10.4 percent in the first quarter of the year.

Figure 5.3: YoY Change in Exports during H1-FY15



Source: Pakistan Bureau of Statistics

Exports

Exports declined by 4.4 percent YoY during H1-FY15, compared to a rise of 4.9 percent last year **(Figure 5.2)**. As mentioned before, the fall in export earnings was observed in Q1 alone, when exporters were uncertain about the global price trajectory, and

[18] The IMF projects disbursements from IFIs and bilaterals at US$ 1.6 billion in Q3, and US$ 1.1 billion in Q4 of FY15 (source: Country Report No 14/357 for Pakistan (after the 4th and 5th reviews).

[19] This section is based on customs data reported by the PBS. This data set also has the advantage over payments record data for analysis purpose, since this carries information on quantums and unit values. The information in this section does not tally with the payments record data, which is reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

[20] It is important to recall here that in the payments records data, the decline in POL import payments had more than offset the increase in non-POL import payments.

withheld the export of rice and POL related products like naphtha. As the slide in oil prices became more pronounced in the second quarter, it became virtually unfeasible for local refineries to sell their products in the international market. However, this was more than offset by an increase in export of most other items like rice, readymade garments, knitwear, synthetic textiles, and cement. As a result, the overall exports increased by 2.4 percent YoY during the second quarter.

Textiles

Textile exports posted a decline of 0.4 percent in H1-FY15 over the same period last year. This decline stemmed primarily from low value-added items: the decline in export of cotton yarn and fabrics more than offset the increase in export of knitwear, woven garments and towels. The export of cotton fabrics to China, Bangladesh and Turkey remained particularly low, as these countries are facing sluggish demand from their importers.[21] On the contrary, export of value-added items like knitwear, and readymade garments benefited from the availability of GSP plus status in the EU.[22] As for the supply side, businessmen cite energy constraints and security risks as being the major issues hurting exports. However, in our opinion, this is only partly true. The fact remains that unless we settle structural issues facing Pakistan's textile industry, it will not be able to consolidate its position in the international market.

Rice

Rice exports posted a growth of 3.5 percent YoY during the first half of FY15. Encouragingly, this growth came on top of 25.9 percent growth last year. Similar to previous few years, we can trace this improvement to an increased demand for Pakistan's non-basmati varieties in the African region, especially in Kenya, Mauritania and Mozambique. In addition, Malaysia has also become one of the five largest importers of Pakistani rice.[23] Presently, non-basmati varieties constitute nearly 85 percent of the rice exported from Pakistan (quantums), and

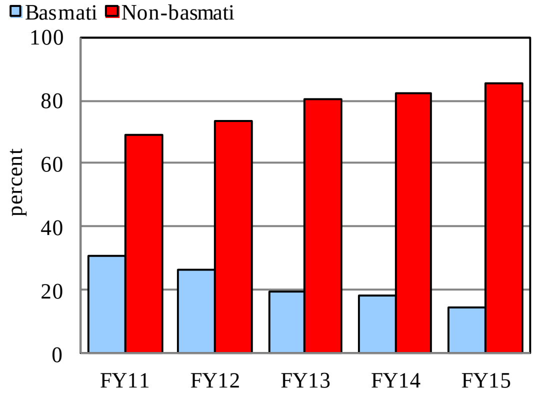
[21] It must be noted that Pakistan has managed to increase its share in import markets of China and Turkey in FY15. For instance in case of cotton fabrics (HS code 5209), Pakistan's share in Turkish market has increased from 21 percent in H1-FY14, to approximately 26 percent in H1-FY15. Similarly in Chinese market, this share has increased from 57 percent in H1-FY14 to 67 percent in H1-FY15 (Source: International Trade Center). Comparable data for Bangladesh is not available.

[22] In fact, overall imports into the EU increased by only 0.2 percent during Jul-Nov 2014, over the same period last year. However the EU's imports from Pakistan increased by a healthy 21.9 percent during the same period. This suggests a significant amount of substitution taking place in the EU market in favor of Pakistan. Some substitution was also seen in case of Pakistan's exports: according to PBS, the share of EU market in our exports increased to 28.8 percent during Jul-Nov FY15 (latest available), compared to 24.8 percent in the same period last year.

[23] According to PBS detailed data for Jul-Nov FY15, Malaysia has become one of our top-5 major exporting destinations for non-basmati.

this share is rising gradually **(Figure 5.4)**.[24] Since non-basmati varieties fetch lower value compared to the basmati, there is a need to capture the markets for basmati rice to earn higher FX earnings.

Figure 5.4: Share of Basmati and Non Basmati in Total Quantum of Rice Exports



Source: Pakistan Bureau of Statistics

Cement

Higher demand from India, Sri Lanka, South Africa, Mozambique, Congo and some other African countries, boosted Pakistan's cement exports during H1-FY15.[25] India's demand for cement was probably an outcome of an increase in public spending on infrastructure and housing. Since most cement production units in India are located on the eastern side, it is more cost effective for western parts to use Pakistani cement for their construction activities. The demand is likely to remain strong going forward, as the government of India plans to consolidate its spending up till 2017, as envisaged in its 12th five year plan (2012-17).

The situation in South Africa is also similar; here also, state-led investment in roads, railway, energy, and water infrastructure has spurred cement demand. Afghanistan was a major exception. Despite all the reconstruction that is being taken place in the country, Pakistan was unable to maintain the previous year's export volumes. Iranian cement has penetrated further into Afghanistan, which competes well with Pakistani variety.

Imports

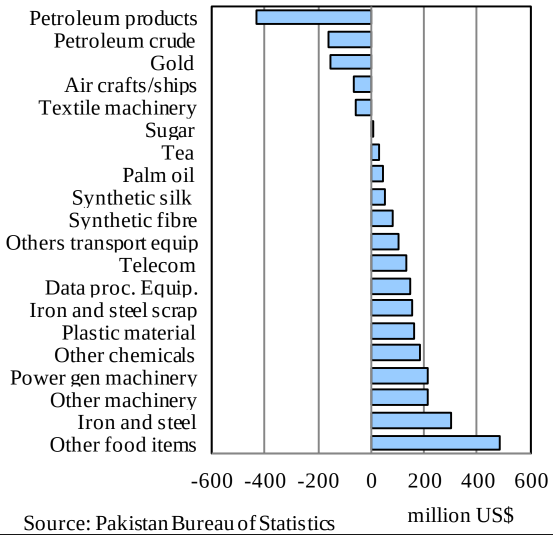
Imports posted a strong growth of 11.5 percent YoY during H1-FY15. Major impetus came from food, machinery, metal and other chemicals, which more than offset the decline in POL imports **(Figure 5.5**). For most non-petroleum products, the decline in unit prices was more than offset by a rise in quantums (**Table 5.3**).

[24] In value terms, however, non-basmati varieties constitute nearly 70 percent of total rice exports.

[25] According to the PBS, quantum cement exports increased by 4.0 percent YoY in H1-FY15, compared with a decline of 5.9 percent in the same period last year.

Within the food import, which increased by US$ 763.2 million over last year, import of 'other food items' remained particularly strong. An increase of US$ 489.3 million was seen in this category: the detailed data (on 8-digit level) suggests that it was the higher demand for low erucic-acid rapeseed, potatoes, peas and other vegetables, which inflated our food import bill.[26] Besides this category, import of tea and palm oil also remained strong, as local manufactures took advantage of falling global prices.[27] Similar impact was seen in case of wheat imports, especially in the months of September and October, when the global prices reached 50-months low.[28]

Figure 5.5: YoY Change in Imports during H1-FY15



Source: Pakistan Bureau of Statistics

Steel rebounded in H1-FY15: posting a growth of 50.0 percent YoY, steel imports (both scrap and products) have reached to an all-time high of US$ 1.4 billion in Jul-Dec 2014. Softening global prices (mainly in China), along with an increase in domestic public works, led to a higher import of steel into the country.[29] However, this higher growth may taper going forward, as the government has recently announced 15 percent regulatory duty on steel billets, bars, wire-rods, etc.[30]

[26] So far, the detailed information is available till November. The Jul-Dec data on 8-digit level, will not be available before April 2015.
[27] Import of tea and palm oil was increased by 18.9 and 87.9 thousand MT respectively during H1-FY15.
[28] This increase in wheat imports was completely uncalled for, keeping in view sufficient stocks in the country. To curb these imports, the government imposed 20 percent regulatory duty on its import in November. As a result, wheat imports declined sharply in November and December to only 57.6 thousand MT, compared to 575.4 thousand MT in the preceding two months.
[29] The average metal price index (IMF) for Jul-Dec 2014, was 10 percent lower than Jul-Dec 2013.
[30] Clearly, this duty favors local steel melters and ship-breakers, who compete directly with imported items. However, this may hurt domestic steel re-rolling industry, which uses these items as input to produce retail products. As per our discussion with the re-rolling industry, the impact of this duty would not reduce imports *significantly*, due to existing difference in quality and specifications. This industry also claims that most imported items would still remain cheaper compared to the locally manufactured ones, even after the imposition of this duty.

Table 5.3: Imports during Jul-Dec FY15 (Decomposition of YoY Change in Value)
million US$

Items	Quantum impact	Price impact	Total change	Items	Quantum impact	Price impact	Total change
Petroleum products	-140.4	-287.8	-428.1	Rubber tyres	42.1	-8.8	33.3
Synthetic yarn	194.9	-143.4	51.4	Soybean oil	7.5	-2.9	4.6
Wheat	145.6	-69.9	75.8	Sugar	1.7	-0.6	1.1
Petroleum crude	-93.6	-68.1	-161.7	Jute	-2.5	0.5	-2.0
Pulses	108.5	-55.7	52.8	Spices	12.3	0.9	13.3
Worn clothing	0.0	-28.0	-28.0	Gold	-152.8	2.6	-150.2
Palm oil	71.4	-25.1	46.3	Raw cotton	-61.1	3.9	-57.3
Synthetic fiber	103.6	-18.1	85.5	Paper	57.5	5.6	63.0
Dry fruits	23.6	-17.8	5.9	Plastic material	144.7	14.8	159.5
Tea	42.8	-14.2	28.6	Insecticides	5.7	15.9	21.7
Iron and steel	319.0	-13.2	305.7	Milk	16.4	29.1	45.5
Rubber crude	8.8	-11.5	-2.7	Fertilizer	-12.3	79.7	67.4
Steel scrap	164.4	-9.2	155.2	Pharma	18.8	120.5	139.3

Source: Pakistan Bureau of Statistics

Machinery imports grew by 24.4 percent in H1-FY15, after declining marginally in the same period last year. This increase was evident mainly in power generating machinery like engines; turbines; and auxiliary plants. This reflects some investment in the domestic energy sector, and increasing use of captive power in other industries. Furthermore, there was an increase of 27.7 percent in the import of machinery, which is not classified elsewhere (*other machinery).*[31]

Trade figures post-December 2014 are not encouraging. Exports have stumbled again in January and February, after showing some recovery in Q2-FY15. Imports, on the other hand, have also fallen in January and February 2015 by 26 percent and 7 percent YoY, respectively. This outcome was expected as global oil prices affect our import unit values with almost a three-month lag.[32] Overall trade deficit has reached US$ 14.6 billion, which is 15.9 percent higher than the same period last year.

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[31] As per the detailed data (HS-8 code), which is available only till November 2014, this increase was reflected in items like plants, parts of pumps, steam turbines and intake air filters.
[32] Import orders for POL are placed around 3 months in advance at prevailing prices. Therefore, the decline in oil prices in October and November 2014 has reflected in our import unit values in January and February 2015, respectively.

Annexure A: Data Explanatory Notes

1) **GDP:** In the absence of actual GDP data, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

Period average inflation (π_{Ht}) = $\left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$

YoY inflation (π_{YoYt}) = $\left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$

Monthly inflation (π_{MoMt}) = $\left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$

Where I_t is consumer price index in t^{th} month of a year.

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

Borrowing from scheduled banks: This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by a quarterly auction of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

   (a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

   (b) **Public debt (MoF vs. SBP):** SBP follows IMF guidelines for compiling public debt, which state that the "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[1] Thus, public debt reported by SBP, is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities.[2]

   While both MoF and SBP follow the same definition of domestic public debt, the coverage of external debt compiled by MoF differs from that of SBP. Specifically, MoF does not include short-term debt, military debt and external liabilities in its compilation of external public debt. As a result, the overall public debt numbers from these two organizations do not match.

   (c) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depend on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP

[1] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."
[2] It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

In addition, the variation in import data also arise due to differences in data coverage, e.g., SBP import data does not include Non-Repatriable Investments (NRI) by non-resident Pakistanis,[3] imports under foreign assistance, land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

[3] The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops.*

Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
BMR	Balancing, Modernization and Replacement
BoP	Balance of Payment
bps	Basis Points
CA	Current Account
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Di-ammonium Phosphate
DISCO	Distribution Companies
ECB	European Common Borad
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FX/FE	Foreign Exchange
FSU	Former Soviet Union
FTA	Free Trade Agreement
FOB	Free on Board
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSP	Generalized System of Preferences
GST	General Sales Tax
HBL	Habib Bank Limited
HS	Harmonized System
IEA	International Energy Agency
IBA	Institute of Business Administration
ICC	International Cricket Council
IDB	International Development Bank

IFI	International Financial Institution
IGC	International Growth Center
IMF	International Monetary Fund
IRC	Interest Rate Corridor
Kg	Kilograms
KPK	Khyber Pukhtunkhwa
LIBOR	London Interbank Offered Rate
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
M2	Broad Money Supply
MFI	Micro Finance Institution
MoF	Ministry of Finance
MRTBs	Market related Treasury Bills
MT	Metric Tons
MW	Mega Watt
NBFC	Non-Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NIM	Net Interest Margin
NFNE	Non-Food Non-Energy
NPK	Nitrogen-Phosphorus-Potassium (fertilizer)
NPLs	Non Performing Loans
NRER	Non-resident (External) Rupee Account
NRI	Non-resident Indians
NRO	Non-resident Ordinary Rupee Account
NSS	National Savings Scheme
OECD	Organization for Economic Co-operation and Development
OEM	Original Equipment Mannufacturer
OGDCL	Oil & Gas Development Company Limited
OMOs	Open Market Operations
OPEC	Oil Producing and Exporting Countries
PASSCO	Pakistan Agricultural Storage & Services Corporation Ltd.
PBS	Pakistan Bureau of Statistics
PDF	Pakistan Development Fund

PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PIDE	Pakistan Institute of Development Economics
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
PPL	Pakistan Petroleum Limited
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSO	Pakistan State Oil
QE	Quantitative Easing
RBI	Reserve Bank of India
rhs	Right Hand Side
ROA	Return on Assets
ROE	Return on Equity
Rs	Rupees
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan
SOEs	State Owned Entities
SR	Saudi Rial
SRO	Statutory Regulatory Order
SWF	Sovereign Wealth Fund
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TDS	Tarrif Differential Subsidies
TPP	Trans Pacific Partnership
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USDA	United States Department of Agriculture
WAPDA	Water and Power Development Authority
YoY	Year on Year
3G/4G	3^{rd} Generation/4^{th} Generation

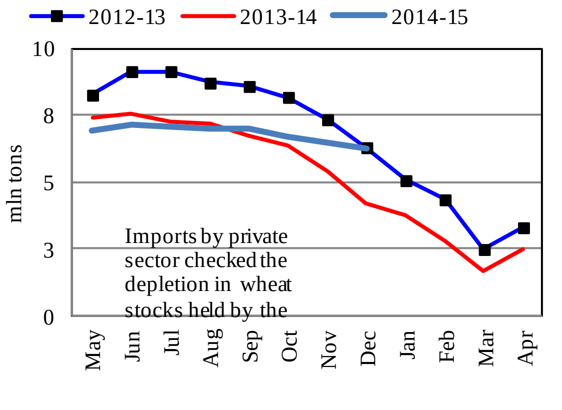
Special Section: Prospects of Wheat Exports

While a better showing by the wheat crop would certainly help overall economic growth, this brings some policy challenges as well. Specifically, with already high level of wheat inventories in the country, the key challenge for the government is to offload this surplus wheat. Given the available stocks and a large (expected) crop size, the government has allowed wheat export of 1.2 million tons. In the backdrop, this section analyzes prospects of wheat export when the global market is in surplus.

A large expected wheat crop in 2014-15, high level of carryover stocks and limited storage capacity put the government in a difficult situation as it has to offload surplus wheat before the arrival of the next crop.[1] In the meantime, the private sector imported 0.7 million tons of wheat in response to a sharp decline in international wheat prices.[2,3] Consequently, the release of wheat stocks held by the government was considerably slower than the norm (**Figure 1**).

One option is to encourage export of these stocks. However, as international wheat prices are even lower than the procurement cost for these stocks, this wheat cannot be exported unless the government provides a subsidy to exporters. Realizing this, in January 2015, the government offered subsidy in the range of US$ 45-55 per ton on the export of 1.2 million tons of wheat from its surplus stocks in Punjab and Sindh.[4,5] Later on, as

Figure 1: Wheat Stock with Government



Source: State Bank of Pakistan

[1] The end-Jan 2015 wheat stock with provincial governments and PASSCO, were as high as 5.80 million tons, considerably higher than 3.75 million tons a year earlier.

[2] The prices of imported wheat ranged from Rs 2,800 to 3,000 per 100 kg bag, inclusive of overhead charges, while government's food department was issuing wheat at Rs 3,450 per bag.

[3] Effective from November 1, 2014, government announced a 20 percent regulatory duty on wheat import.

[4] Accordingly, Punjab will export 800,000 tons while Sindh has been allocated export quota of 400,000 tons of wheat.

international prices fell further, the government raised the subsidy to US$90 per ton. [6]

Even after adjusting for this subsidy, the FOB price of wheat at Karachi port comes around US$ 275 per ton (**Table 1**), which still exceeds the current rate of $210-220 per MT offered by the Russian Federation and Ukraine by a wide margin. Unfortunately, global wheat prices are likely to remain low in near future due to a record crop and a large buildup in stock, weak demand, and a better supply of competing grains (**Box 1**).[7]

Table 1: Estimates of FOB Price of Wheat

Wheat issue price	1,300	Rs per 40 kg
Price per ton	32,500	Rs per ton
Cost of jute bag	1,240	Rs per ton
Transportation to Karachi	1,500	Rs per ton
Other costs[1]	2,200	Rs per ton
Wheat cost at port (Rs)	37,440	Rs per ton
Wheat cost (fob at Karachi port)	368.2	US$/ton
Government subsidy for export of wheat	90	US$/ton
Subsidy Adjusted FOB Price	**278.2**	US$/ton

Source: Traders in the market.

[1.] This includes warehousing charges, fumigation cost, pre-shipment inspection fee, exporters' margin etc.

In this scenario, supporting farmers against the continuing depressed prices of their produce is not an easy task. On one hand, availability of surplus wheat may drag down the market price below the support price of Rs 1,300 per 40 kg. On the other hand, potential procurement volume is constrained by available storage capacity. Even if the government procures wheat in large volume, it may not be able to export the surplus quantity due to lower prices in the international market. Hence, this may lock-in a significant amount of money in wheat finance. It may be noted that the outstanding stock of commodity loans against wheat procurement has already reached at Rs 363 billion by end-December 2014.

[5] Furthermore, taking notice of unhindered import of wheat byproducts, the government also issued instructions for immediate ban on their import.
[6] Interestingly, almost a similar situation has evolved in the sugar sector. In view of depressed international prices and surplus sugar stock in the country; government has allowed 650,000 tons of sugar export till 15th May 2015. Furthermore, to get rid of surplus stocks ahead of fresh sugar, government also offered a price subsidy of Rs 2 per Kg on inland freight and Rs 8 per Kg in cash.
[7] The World Bank also expects wheat price decline to extend in 2015 as well.

Box 1: Recent Trends in Global Wheat Production

According to recent estimates from US Department of Agriculture (USDA), the global wheat production is expected to reach 725 million tons in 2014-15, which is the second consecutive year of record wheat production (**Table 1.1**).[8] While crop in US, Canada and Australia is likely to suffer due to dry spell, growing conditions remained favorable in EU, FSU, India and China. In overall terms, the improvement in production was driven by both increase in area harvested and higher yields (**Figure 1.1**).

In the meanwhile, according to USDA, global wheat consumption in 2014-15 is expected to increase by 1.5 million tons on both higher food and feed use. As a result, wheat stocks are likely to reach 197.9 million tons at the end of current crop season.

The global trade in wheat is likely to remain low due to increased production in key importers (e.g., China), and a healthy growth in other competing grains (e.g., corn and soybean).

Hence, with a steady buildup in global wheat stock, no immediate pressure on the demand, and low global trade, it is expected that the market prices of wheat will be driven more by supply-side conditions. In case if weather remains favorable, increased wheat production is likely to keep market prices under pressure.

Table 1.1: World Wheat Supply and Stock

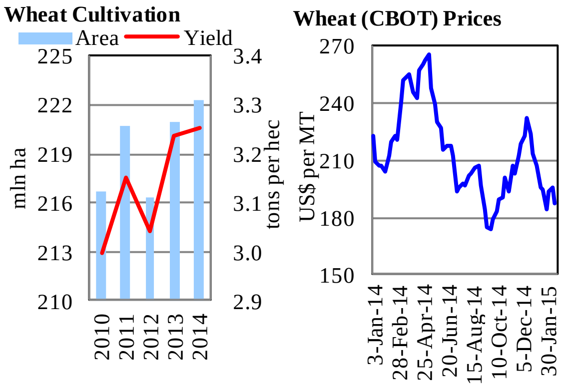
million tons

	2012-13	2013-14	2014-15[P]
World supply	**658.5**	**716.1**	**725.0**
EU	134.0	143.5	155.7
China	121.0	121.9	126.0
FSU[1]	77.8	103.9	112.3
India	94.9	93.5	95.9
US	61.3	58.1	55.1
Pakistan	23.3	24.0	25.0
Australia	22.9	27.0	24.0
Canada	27.2	37.5	29.3
Wheat stock	**175.5**	**187.5**	**197.9**

[1.]Former Soviet Union states; [P] Projection

Source: US Department of Agriculture

Figure 1.1: Global Wheat Crop and Prices



Souurce: US Department of Agriculture

[8] These estimates, issued in February 2015, were slightly higher than their previous projections of 723 million tons.